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BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Commodity Futures Regulation--Current Status And Unresolved Problems

ORIGINAL

350

GAO recommends that the Congress reauthorize Federal commodity regulatory programs this year. Since 1978, when the Commission was last reauthorized, it has made progress in developing a regulatory framework to protect commodity customers.

The Commission's principal programs--including registration of commodities professionals, contract approval and market surveillance, review of commodity exchanges' efforts to enforce their own rules, and a reparations system--can be improved. GAO makes specific recommendations for upgrading these programs.

Despite their need for improvement, these programs must be reauthorized if rapidly expanding futures trading is to operate reasonably free from abuse. Even if the exchanges can assume an increasing share of the responsibility for regulating their own activities--an important Commission objective--there will be a continued need for Federal monitoring of industry self-regulatory programs.

UNITED STATES GENERAL ACCOUNTING OFFICE

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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To the President of the Senate and the
Speaker of the House of Representatives

This report evaluates selected programs of the Commodity Futures Trading Commission which regulate commodity futures markets and which support the efforts of these markets to regulate themselves. The report includes many recommendations for improving these programs.

We undertook this review to assist the Congress in evaluating the Commission's performance in conjunction with the reauthorization of the Commission, which is currently being considered by the Congress. This review also serves to follow up on our 1978 recommendations regarding the Commodity Futures Trading Commission.

We are sending copies of this report to the Director, Office of Management and Budget; the Chairman, Commodity Futures Trading Commission; the Attorney General; and other interested parties.

Charles A. Bowsher

Comptroller General
of the United States

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

COMMODITY FUTURES REGULATION--
CURRENT STATUS AND
UNRESOLVED PROBLEMS

DIGEST

Trading in futures contracts on the Nation's 11 commodity exchanges has grown dramatically during the last decade. For example, in 1970 over 13 million contracts valued at $148 million were traded on the Nation's commodity exchanges compared with 101 million contracts valued in the trillions being traded in 1981. Also, the concept of a commodity has expanded to include financial instruments, such as Treasury bills and bonds and stock indexes, in addition to traditional commodities, such as wheat and soybeans. This growth and expansion has increased the importance of futures trading in the Nation's economy.

To oversee commodity futures trading, the Congress, in 1974, created the Commodity Futures Trading Commission. The Commission's current authorization expires in 1982. GAO undertook this review of the Commission's activities to help the Congress evaluate the Commission's performance and consider changes to the Commission's enabling legislation. GAO's findings regarding needed improvements in Commission programs are based on an assessment of whether the Commission's programs meet the objectives established by the Congress and measure up to the Commission's own stated objectives.

FEDERAL COMMODITY REGULATION IS ESSENTIAL

GAO recommends that the Congress reauthorize Federal commodity regulatory programs in 1982. Since 1978, when the Commission was last reauthorized, it has made progress in developing a regulatory framework to protect commodities customers. The principal Federal programs for commodity futures regulation--including registration, market surveillance, and review of commodity exchanges' rule enforcement--must continue if futures trading is to operate reasonably free from abuse. Even if exchanges

JULY 15, 1982

assume increasing responsibility for key aspects of regulating futures trading--an important Commission objective--the Federal Government must continue to monitor exchange performance to determine whether self-regulation is working acceptably. (See p. 9.)

INDUSTRY SELF-REGULATION

The Commodity Exchange Act requires exchanges to establish and enforce rules to govern futures trading. One of the Commission's most important programs is reviewing exchanges' rule enforcement procedures and performance. The Commission's reviews have not covered all aspects of exchange programs often enough and have not promptly followed up on previously identified deficiencies. Consequently, the rule enforcement review program has not brought about needed improvements in exchange self-regulation. GAO recommends that the Commission (1) improve the criteria it uses to assess exchange rule enforcement programs, (2) conduct more frequent reviews, and (3) link approval of trading in a new futures contract at an exchange with exchange adherence to the act's and the Commission's self-regulatory requirements. (See p. 134.)

ECONOMIC FUNCTION OF FUTURES MARKETS

Futures markets help establish cash prices or provide an opportunity to hedge the risk of commodity ownership. The Commission reviews and approves futures contracts before they are traded to ensure that they will serve these functions. After trading begins, the Commission and the exchanges maintain market surveillance programs to detect market manipulation and other harmful activity.

Since GAO's 1978 review, the Commission has improved its assessment of proposed futures contracts. For example, it now more thoroughly analyzes information submitted to support contract approval; however, the Commission still needs to strengthen and clarify its approval requirements.

The Commission has focused much effort on approving new contracts at the expense of reviewing contracts that are already being traded. GAO believes the Commission should devote more effort to existing contracts to determine that they are actually meeting their economic function. GAO recommends that the Commission offset the expenses of contract review and approval by charging exchanges a user fee when they submit contracts for approval. (See p. 33.)

In conducting its market surveillance program, the Commission collects, analyzes, and compares, on a daily basis, data on supply and demand conditions in the cash and futures markets, and, in particular, on the size and dominance of traders' market positions. Weaknesses in its overall automatic data processing programs prevent the Commission from collecting and analyzing this data in a way that can effectively support its surveillance program. GAO, therefore, recommends improvements in the Commission's collection and processing systems. (See p. 55.)

In addition, the Commission needs to ensure that exchanges have sufficient data to carry out their share of market surveillance. GAO recommends that the Congress amend section 8a(6) of the Commodity Exchange Act to allow the Commission to share data on traders' positions with the exchanges. (See p. 56.)

PROTECTION OF FUTURES CUSTOMERS

The Commission maintains three major customer protection programs--registration of commodity professionals, auditing and financial surveillance of firms dealing in commodities, and reparations. The Commission's efforts to register industry professionals and to identify and remove unfit individuals can be improved. For example, although the Commission has required commodity trading advisors and commodity pool operators to register, the salespersons and supervisors who actually solicit business for these firms are not presently required to do so. (See p. 68.)

The Commission can take additional actions to assure registrants' fitness by requiring futures commission merchants to (1) sponsor and review the registration application of persons associated with their firms and (2) fingerprint registrants and submit their fingerprints to the Federal Bureau of Investigation for review. (See p. 63.)

The newly created National Futures Association is expected to assume many of the Commission's registration responsibilities. The Commission, however, needs to more actively plan for the transfer of registration functions to the Association. To overcome existing limitations on the Association's registration authority and allow a more complete transfer of responsibility, GAO recommends that the Congress amend the Commodity Exchange Act to authorize the Association to assume registration functions now performed by the Commission. (See p. 74.)

AUDIT AND FINANCIAL SURVEILLANCE

The Commission tries to deter financial failures and detect improper financial practices that could lead to loss of customer funds. The Commission shares this responsibility with the commodity exchanges, which establish and enforce minimum financial requirements for their members. The Commission monitors exchange audit and financial surveillance programs. (See p. 76.)

GAO recommends that the Commission place more reliance on surveillance by the exchanges and the National Futures Association when it begins operating. In doing so, however, the Commission will need to improve its program for monitoring exchange audit and financial surveillance activities. GAO believes this shifting of focus will allow the Commission to devote more audit resources to other areas for which it is primarily responsible. (See p. 77.)

FORUMS FOR ADDRESSING CUSTOMER CLAIMS

In 1974 the Congress amended the Commodity Exchange Act to establish a reparations program as a forum for resolving disputes between commodity customers and industry professionals. The reparations program is not meeting its objectives: statistics indicate that a complaint takes an average of 3 years to complete the entire reparations process; complainants have difficulty understanding the program; and reparations is expensive--commodity attorneys charge fees ranging from $1,500 to $10,000. (See p. 182.)

To improve the reparations program, GAO recommends that the Commission (1) improve its collection of information essential to program management, (2) make the program's operation clearer to participants, and (3) develop arbitration as a more effective alternative to reparations. (See p. 194.) To increase the potential for use of arbitration, GAO recommends that the Congress raise from $15,000 to $25,000 the dollar limit for claims that customers can compel exchange members to arbitrate. (See p. 195.)

AUTOMATIC DATA PROCESSING

The Commission must collect and analyze large amounts of data to accomplish its regulatory functions. The Commission's information resources, however, have become outdated and do not adequately support its programs. GAO recommends that the Commission establish a process that gives direction to the automatic data processing program and develop agency-wide standards to plan and control software development. These steps will serve to update and improve the Commission's management of its information resources. (See p. 215.)

AGENCY AND OTHER COMMENTS AND GAO's EVALUATION

In March 1982 GAO provided a draft version of this report to the Commission, to other interested Federal agencies, and to affected commodities exchanges. The Commission expressed concern that the report did not recognize the agency's progress in strengthening its management since GAO's 1978 review. The Commission also stated that it had adopted or was in the process of adopting more than 30 specific actions recommended by GAO. GAO has revised the report to reflect these recent actions more fully.

In comments pertaining to individual chapters of the report, the Commission made suggestions for updating, clarifying, and in some cases correcting GAO's statements. The Commission's comments were most numerous and detailed concerning two chapters dealing with its audit and financial surveillance and rule enforcement review programs which it believed contained inaccuracies. (See chs. 6 and 7.) GAO has addressed all of the Commission's comments at the conclusion of the chapters to which they pertain. GAO has modified the report where appropriate in response to these comments. GAO accorded similar treatment to the comments of various commodity exchanges, the National Futures Association, and the Department of Justice. (See apps. XV and XVI, respectively, for the complete text of agency comments and comments from exchanges and other parties.)

Contents

Page

DIGEST i

CHAPTER

1 INTRODUCTION 1
- Theory and practice of futures trading 1
- Growth and diversification of the futures industry 2
- CFTC's organization and functions 3
- Objectives, scope, and methodology 4

2 FEDERAL PROGRAMS REGULATING COMMODITY FUTURES TRADING SHOULD BE REAUTHORIZED 7
- Why Federal regulation of futures trading needs to be reauthorized 7
- Federal commodity regulatory programs should be reauthorized 9
- Conclusions 9
- Recommendation to the Congress 10

3 CFTC's CONTRACT APPROVAL AND REVIEW PROCESS CAN BE IMPROVED 11
- CFTC can refine its process for approving futures contracts 11
- CFTC needs to devote more attention to existing contracts 18
- Improved administrative procedures could reduce the time needed for contract approval 23
- Exchanges should be assessed user charges for contract approval 29
- Conclusions 31
- Recommendations to the Chairman, CFTC 32
- Agency comments and our evaluation 33
- Exchange comments and our evaluation 35

4 MARKET SURVEILLANCE IMPROVEMENTS DEPEND ON BETTER DATA COLLECTION AND ANALYSIS 38
- How market surveillance works 38
- CFTC can further improve its collection of large-trader data 39
- CFTC makes little use of ADP to analyze surveillance data, resulting in a weaker surveillance effort 45
- Commodity exchanges need to be primarily responsible for market surveillance 48
- Conclusions 53

CHAPTER Page

Recommendations to the Chairman, CFTC 54
Recommendation to the Congress 55
Agency comments and our evaluation 55
Exchange comments and our evaluation 55
Other comments and our evaluation 58

5 IMPROVEMENTS TO CFTC's REGISTRATION PROGRAM COULD PROVIDE BETTER CUSTOMER PROTECTION 59
The purpose and process of CFTC's registration program 59
Our prior recommendations concerning registration fitness and qualification requirements 61
Implementing associated person sponsorship and fingerprinting has been delayed by a lack of essential support capabilities 62
CFTC has not upgraded its registration program by performing periodic fitness checks 64
Proficiency testing has not been implemented 65
CTA and CPO sales personnel need to be registered 67
Questions need to be resolved concerning registration functions that will be assumed by a registered futures association 68
Conclusions 71
Recommendations to the Chairman, CFTC 72
Recommendations to the Congress 73
Agency comments and our evalution 73
Other comments and our evaluation 74

6 CFTC NEEDS TO ALLOCATE AUDIT AND FINANCIAL SURVEILLANCE RESOURCES MORE EFFECTIVELY 75
CFTC performs direct audits and monitors exchange audit and financial surveillance programs 75
CFTC's audit resources could be better utilized 76
CFTC action needed to strengthen exchanges' audit and financial surveillance programs 85
Conclusions 93
Recommendations to the Chairman, CFTC 94
Agency comments and our evaluation 94
Exchange comments and our evaluation 100
Other comments and our evaluation 101

CHAPTER Page

7 NEED FOR CONTINUED IMPROVEMENT IN CFTC's RULE ENFORCEMENT REVIEW PROGRAM AND EXCHANGE SELF-REGULATION 102
  Exchange self-regulatory responsibilities and CFTC regulatory oversight 102
  Overview of rule enforcement review program: progress in some areas, additional improvements needed 105
  What rule enforcement reviews tell us about the current state of exchange self-regulation 114
  CFTC needs better planned, more thorough, and more comprehensive rule enforcement reviews 119
  A continued need exists for improved criteria by which to assess exchange rule enforcement programs 124
  Contract market designation needs to be more closely linked with exchange adherence to self-regulatory requirements 128
  Conclusions 131
  Recommendations to the Chairman, CFTC 133
  Agency comments and our evaluation 134
  Exchange comments and our evaluation 159

8 REPARATIONS AND OTHER MEANS OF RESOLVING CUSTOMER CLAIMS ARE INADEQUATE 165
  Program objectives--to be fast, easy, and inexpensive 165
  How the reparations program works 166
  The complaints screening process works relatively well 168
  Despite significant progress in some areas, other aspects of the reparations program still need improvement 170
  Management information capabilities are inadequate 183
  Presently available alternatives to the reparations program have problems of their own 185
  Conclusions 192
  Recommendations to the Chairman, CFTC 193
  Recommendations to the Congress 194
  Agency comments and our evaluation 195
  Exchange comments and our evaluation 197
  Other comments and our evaluation 198

CHAPTER Page

9 CFTC CAN MORE EFFECTIVELY MANAGE ITS ADP RESOURCES 199
Description of ADP systems and resources 199
Outdated ADP systems have not effectively supported CFTC programs 200
CFTC can establish an effective ADP planning structure 201
CFTC needs an effective ADP management structure 204
Conclusions 213
Recommendations to the Chairman, CFTC 214
Agency comments and our evaluation 215

APPENDIX

I Futures trading on the U.S. exchanges--volume of trading, fiscal years 1956-81 216

II Total value of contracts traded 1970 to 1980 217

III Commodities for which markets are designated to trade as of January 1, 1982 218

IV CFTC appropriation and employment history fiscal years 1976-81 226

V CFTC organization chart 227

VI Organization and responsibilities of CFTC's operating divisions 228

VII Major organizations and agencies contacted in the course of our review 231

VIII Contract approvals examined during our review 233

IX Other GAO reports concerning commodity futures regulation 234

X Central computer system history 235

XI The number of complaints CFTC used to determine the estimated average number of days it took to move complaints through the entire reparations process 237

XII Proposed amendments to the Commodity Exchange Act 239

XIII Division of Trading and Markets' rule enforcement reviews 242

APPENDIX Page

XIV Comparison of findings of rule enforcement reviews 1976-81 245

XV Letter of March 8, 1982, from the Chairman, CFTC 256

XVI Comments received from the exchanges and other parties 284

ABBREVIATIONS

ADP	Automatic data processing
AICPA	American Institute of Certified Public Accountants
ALJ	Administrative Law Judge
AP	Associated Person
CFTC	Commodity Futures Trading Commission
CPO	Commodity Pool Operator
CTA	Commodity Trading Advisor
FB	Floor Broker
FBI	Federal Bureau of Investigation
FCM	Futures Commission Merchant
GAO	General Accounting Office
NFA	National Futures Association
OMB	Office of Management and Budget
SEC	Securities and Exchange Commission

GLOSSARY

Accommodation trading	A type of wash trading (see definition) entered into by a trader, usually to assist another with illegal trades.
Arbitrage	The simultaneous purchase of cash commodities or futures in one market against the sale of cash commodities or futures in the same or different market to profit from a discrepancy in prices.
Bucketing	The illegal practice of accepting orders to buy or sell futures contracts without executing such orders and the illegal use of the customer's margin deposit.
Cash (spot) market	The market for immediate delivery of and payment for actual, physical commodities.
Churning	Excessive trading which permits the broker to derive a profit while disregarding the best interests of the customer.
Congestion	A market situation where traders in a short (selling) position are unable to find an adequate supply of offsetting contracts from new traders or traders in a long (buying) position except at sharply higher prices.
Contract market designation	The process through which an exchange, in return for meeting the section 5 requirements of the Commodity Exchange Act, is designated by CFTC as a contract market, allowing it to trade futures contracts in a specific commodity.
Corner	Securing such relative control of a commodity that its price can be manipulated. In an extreme situation, cornering involves obtaining futures contracts requiring delivery of more commodities than are available for delivery.
Cross trading	Offsetting or noncompetitive matching of the buying order of one customer against the selling order of another, a practice that is permissible only when executed as required by the Commodity Exchange Act, CFTC regulations, and commodity exchange rules.

Debit/deficit	An audit to assess the impact of deficits on a futures commission merchant's ability to meet minimum financial and other requirements. A deficit occurs in an account if (1) the ledger balance and open trades in the account liquidate to a deficit or negative amount or (2) the account contains a debit or negative ledger balance with no open trades.
Deliverable supply	The quantity of a commodity that conforms to, or can be made to conform to, the delivery requirement of the futures contract and is available to the sellers at a cost no greater than the commodity's actual commercial value.
Exchange of futures for cash	A transaction in which the buyer of a cash commodity transfers to the seller a corresponding amount of long futures contracts or receives from the seller a corresponding amount of short futures at a price difference mutually agreed upon.
Fitness check	Reviewing Federal Bureau of Investigation files to determine if there is evidence of an arrest record or conviction for the individual in question. At the Securities and Exchange Commission, files are reviewed to determine if the individual has committed any securities-related crimes and violations.
Forward contracting	A cash transaction common in many industries, including commodity merchandising, in which the buyer and seller agree upon delivery of a specified quality and quantity of goods at a specified future date. A price may be agreed on in advance, or there may be agreement that the price will be determined at the time of delivery.
Futures contract	A firm commitment to deliver or receive a specified quantity and grade of a commodity during a designated month with price being determined by public auction among exchange members.
Hedging	Taking a position in a futures market opposite to a position held in the cash market to minimize the risk of financial loss from an adverse price change.

Large trader	An individual or corporation that holds or controls a position in any one future of a commodity or any one contract market equaling or exceeding a given reporting level.
Leverage contract	A standardized agreement calling for delivery of a commodity with payments against the total cost spread out over a period of time.
Liquidation	The process of offsetting one outstanding futures position (long/short) with another (short/long). As a futures contract enters its final days of trading, the amount of unliquidated contracts--open interest--will decline as traders liquidate their positions or take delivery.
Long	(1) One who has bought a futures contract to establish a market position, (2) a market position which obligates the holder to take delivery, or (3) one who owns an inventory of commodities.
Managed account CTA	A commodity trading advisor managing commodity trading accounts for customers.
Margin	The money deposited by a client with his or her broker, or by a broker with the clearinghouse, as a guarantee of performance on the purchase or sale of a futures contract.
Open interest	The sum of futures contracts to one delivery month or one market that has been entered into and not yet liquidated by an offsetting transaction or fulfilled by delivery.
Option	A unilateral contract that gives the buyer the right to buy or sell a specified quantity of a commodity at a specific price within a specified period of time, regardless of the market price.
Order	An authoritative communication to buy or sell a futures contract at whatever price is obtainable at the time it is entered in the trading arena (pit).

Position	An interest in the market, either long or short, in the form of one or more open contracts.
Prearranged trading	Trading between brokers in accordance with an expressed or implied agreement or understanding.
Price basing	Using prices discovered through futures trading to estimate cash prices for commodities in localized markets as well as in related services such as storage, transportation, and processing.
Price manipulation	A planned operation, transaction, or practice calculated to cause or maintain an artificial price--one which is not reflective of supply and demand conditions.
Segregation	Recording and accounting, for each customer, the money, securities, and property received by a futures commission merchant to margin, guarantee, or secure the trades or contracts of the commodity customer.
Short	(1) The selling side of an open futures contract or (2) a trader whose net position in the futures market shows an excess of open sales over open purchases.
Speculative position limits	Limits that set a maximum on the futures positions a speculator can hold. Speculative position limits do not apply to futures positions that are hedged in the cash market.
Trading ahead of a customer	A floor broker making a trade in his or her personal account while holding an executable customer order.
Trading outside the daily trading range	A floor broker making a trade at a price above or below that established during the daily trading session.
Transfer trades	Entries made upon the books of futures commission merchants for the purpose of transferring existing trades where no change in ownership is involved from one account to another or exchanging futures for cash commodities.

Wash trades	Entering into, or purporting to enter into, transactions for the purpose of giving the appearance that purchases and sales are being or have been made.

CHAPTER 1

INTRODUCTION

The dramatic growth in the volume and value of futures trading that occurred in the 1970's has continued into the present decade. In fiscal year 1970, 13.6 million contracts valued at $148 billion were traded on the Nation's commodity exchanges. By fiscal year 1981 the numbers had grown to more than 101 million contracts valued in the trillions. At the end of 1978, the year we issued our last report on the Commodity Futures Trading Commission (CFTC), 1/ the Nation's 11 commodity exchanges were trading 94 different futures contracts. By the end of 1981, exchanges were trading 108 different futures contracts.

Today, the types of futures contracts traded include not only those dealing with agricultural commodities (both new and traditionally traded ones) but also an increasing number of innovative futures contracts in interest-rate instruments (Treasury instruments, commercial paper, certificates of deposit); energy products; and other areas. In recent months, CFTC has approved several contracts for futures trading on equity indices. In the near future, as a result of CFTC's recent approval of a pilot program for commodity options trading and the resolution of long-standing jurisdictional differences between CFTC and the Securities and Exchange Commission, even further rapid growth and diversification of the futures industry is expected.

Many of the recommendations in this report are aimed at improving the effectiveness and efficiency of commodity futures regulation by redefining and reassigning regulatory responsibilities in such a way as to strike, what we believe to be, a more appropriate balance between direct Federal Government regulation and Federal Government oversight of industry self-regulation. Through more effective use of modern information processing technology and techniques; through redefinition and shifting of regulatory roles and responsibilities; and through judicious use of the substantial licensing, enforcement, and other powers available to it, CFTC would be able to anticipate and accommodate the requirements of a dynamic and evolving industry. Most importantly CFTC would be able to continue to increase the effectiveness of commodity regulation and the important safeguards such regulation is intended to provide.

THEORY AND PRACTICE OF FUTURES TRADING

Commodity futures trading is the buying and selling of standardized contracts for the future delivery of specified

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1/"Regulation of the Commodity Futures Markets--What Needs To Be Done" (CED-78-110, May 17, 1978).

grades and amounts of commodities. It is distinguished from cash market (or spot market) trading where the physical commodity itself is involved. Futures markets are closely related to cash markets and, when functioning properly, enable the cash markets to work more effectively by helping to establish cash prices and by permitting cash market participants (producers, middlemen, and commercial users or processors of a commodity) to protect themselves from adverse movements in the price of the physical commodity in which they deal. Futures contracts are traded by competitive, open outcry bidding on organized commodity exchanges (also referred to as boards of trade) that are licensed and overseen by the Federal Government. Futures trading has two primary theoretical justifications:

> Price discovery - This is the process through which traders buying and selling futures contracts in the exchange arena (or pit) "discover" the competitive prices that best represent the consensus of what traders think commodity prices ought to be in the future based on information available today. Broad dissemination and publication of exchange-generated prices can foster competition in establishing cash prices for commodities in localized markets as well as in related services such as storage, transportation, and processing.

> Risk shifting - This function provides an opportunity for shifting the risks associated with commodity ownership from individuals and entities who are unwilling to bear such risks to those who are willing to carry these risks in return for a possible profit. This risk-shifting process is known as hedging. Those who seek to shift risk are known as hedgers, and those willing to assume risk in return for potential profit are known as speculators. Speculators, unlike hedgers, generally have no interest in the physical commodity itself. They are interested solely in speculating on the extent and direction of future price changes. By standing ready to purchase or sell futures contracts based on price alone, speculators increase the liquidity, efficiency, and competitiveness of markets. Their facilitation of the process of hedging provides greater price certainty and enables hedged firms to operate at lower costs and to potentially pass those lower costs on to consumers.

GROWTH AND DIVERSIFICATION OF THE FUTURES INDUSTRY

By 1974 the growth in the industry had become so dramatic that the Congress created a new, independent regulatory structure to deal with it. The Commodity Futures Trading Commission Act of 1974 (Public Law 93-463, 88 Stat. 1389, Oct. 23, 1974) established CFTC. In the last 6 years, a period which essentially dates from CFTC's creation, the number of active futures contracts traded has increased 75 percent while trading volume has almost quadrupled, to more than 100 million contracts per year. The value of contracts traded is now estimated to be in excess of $5 trillion. Appendix I shows the volume of trading at the Nation's commodity exchanges from 1956-81. Appendix II shows the value of futures contracts traded from 1970-80. Appendix III lists commodities and the exchanges allowed to trade futures contracts in these commodities as of January 1, 1982.

Several factors underlie the increased volume and importance of futures trading. A prominent factor has been the economic uncertainty of recent years which, along with high inflation and high interest rates, has caused money to become widely recognized as a "commodity." This has led to the creation of various new financial futures instruments to enable investors and others who deal in currency and money market instruments to seek ways of managing the risks and uncertainties involved in their businesses. In addition, increased commercial participation in the futures markets by many other interests--home builders, real estate developers, millers, livestock feeders, manufacturers, merchandisers, and farmers--has added to the economic importance of futures trading. This increased commercial participation reflects a growing awareness and understanding of futures markets and greater appreciation of the usefulness of futures as a marketing, pricing, and risk-management tool.

CFTC'S ORGANIZATION AND FUNCTIONS

CFTC was established by Congress in 1974 and began operating in April 1975. The 1974 act only authorized CFTC to operate through fiscal year 1978. CFTC's authority to regulate futures trading was renewed by the Congress in 1978 for an additional 4 years; this authorization expires on September 30, 1982. 1/ As of January 1982, CFTC's jurisdiction extended to the trading of 108 contracts on 11 organized commodity exchanges. It also includes trading in several off-exchange instruments (so called because they are not traded on organized exchanges), some of which are traded legally, but some of which are simply fraudulent or traded in violation of current provisions of the act or of CFTC rules. This latter category of off-exchange instruments has constituted a major enforcement burden for the Commission in recent years.

CFTC is governed by five Commissioners who are appointed by the President, with the advice and consent of the Senate. The President, with the advice and consent of the Senate, designates one Commissioner to serve as Chairman. Commissioners serve staggered 5-year terms, and by law no more than three can belong to the same political party. During our review, several changes

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1/CFTC was reauthorized by the Futures Trading Act of 1978 (Public Law 95-405, 92 Stat. 865).

occurred in CFTC's composition, including a change of chairmanship (with the former Chairman remaining as a Commissioner) and the replacement of two Commissioners whose terms had expired.

CFTC was established to ensure that futures trading is fair and that it protects both the rights of customers and the financial and economic integrity of the marketplace. The agency approves the rules under which an exchange proposes to operate and monitors exchange enforcement of those rules. It reviews the terms of proposed contracts and registers firms and individuals who handle customer funds or give trading advice. It also protects the public by enforcing rules that require (1) customer funds to be kept in bank accounts separate from accounts maintained by firms for their own use and (2) customer accounts to be marked to present market value at the close of each trading day.

CFTC's work is carried out by six operating components--the Divisions of Enforcement, Economics and Education, and Trading and Markets and the Offices of Executive Director, General Counsel, and the Chairman. CFTC is centralized and headquartered in Washington, D.C., and has five regional offices--large offices in Chicago and New York (cities in which 8 of the Nation's 11 futures exchanges are located), smaller regional offices in Kansas City and San Francisco, and a suboffice (of the Chicago regional office) in Minneapolis. The New York City (eastern region) and Chicago (central region) offices are staffed with personnel from each of the three operating divisions. The Kansas City office (southwest region) is staffed with Trading and Markets and Economics and Education Division personnel and the San Francisco office (western region) is staffed solely by Enforcement Division personnel. During fiscal year 1980 the agency established a southern region office within Washington headquarters which, like San Francisco, is comprised only of Enforcement Division staff. (An organization chart appears in app. V.) The organization and responsibilities of CFTC's major divisions and offices are discussed in appendix VI.

At the end of fiscal year 1981, CFTC had a full-time staff of 469. Its total appropriations for fiscal year 1981 amounted to $18,781,000. Compensation and benefits accounted for more than 75 percent of the agency's budget. CFTC's staffing level and its appropriations (particularly when inflation is taken into account) have remained constant since the end of fiscal year 1976, CFTC's first full year of operation. CFTC's fiscal year 1982 budget is expected to be approximately $20,800,000, which will support about 470 full-time permanent staff years. (See app. IV for appropriations and employment history.)

OBJECTIVES, SCOPE, AND METHODOLOGY

We undertook this review of selected CFTC programs to help the Congress (1) evaluate CFTC's performance since it was reauthorized in 1978 and (2) consider whether the regulatory programs of CFTC should be reauthorized again and, if so, in what form and with what specific authorities. This report draws and builds upon work we did in 1977-78 and represents a continuation of our longstanding concern with the overall effectiveness of commodity futures regulation. (See app. IX for a list of our reports dealing with this subject.) Our work was done in accordance with our current "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

This review was not as comprehensive and wide-ranging as our 1978 review. In selecting programs and issues to include in our review, we took into account the findings and recommendations of our last report, actions taken (or not taken) by the agency to implement our prior recommendations and to address identified problems and needs, and developments at the agency and in the regulated industry since 1978.

This review, in contrast to our 1978 review, did not include an evaluation of CFTC's overall organization and management or its comprehensive planning efforts. Our preliminary examination of CFTC management and direction revealed that the agency had made substantial progress in overcoming the management difficulties experienced in its early years and that a number of steps had been taken since 1978 to formalize and institute the planning process as a basic management function and decision tool.

Our findings regarding needed improvements in CFTC's programs are based on an evaluation of whether CFTC's programs meet the objectives established by the Congress in CFTC's enabling legislation and whether the programs measure up to CFTC's own stated objectives. Additionally, an important measure in our current review was CFTC's progress in meeting these objectives since our 1978 review. We have not attempted a comprehensive review of the current extent of market disruptions, fraud, or other problems in commodity futures trading.

To accomplish our objectives, we initially conducted an extensive review of pertinent economic literature and our previous reports, CFTC documents, reports, records and data, congressional oversight hearings, and legislative histories. We met frequently with CFTC's Chairmen (the present Chairman as well as his immediate predecessor), with the other Commissioners, and with CFTC division and office staff at all levels.

We often relied on oral interviews with the responsible agency officials to determine what action CFTC had taken in response to deficiencies identified in 1977-78. In all cases, we solicited information from, and discussed our findings with, the most appropriate and cognizant CFTC official. Where we believed additional investigation was warranted to confirm oral information, collateral and corroborated data was collected.

We contacted several industry representatives, including officials of major exchanges in New York and Chicago, officials of industry trade and self-regulatory associations, and representatives of other Federal departments and agencies for their views on a variety of regulatory issues. In conjunction with our review of CFTC's reparations program (and relevant alternatives), we contacted several attorneys recommended by CFTC officials and a nonscientific sampling of complainants who had received various types of judgments while we were conducting our review. (A listing of groups, organizations, and agencies contacted is in app. VII.) We also used staff who had gained expertise in futures trading and regulation during our last review. All of our staff on this review attended the Futures Industry Association's course on futures trading.

Our review was conducted at CFTC headquarters in Washington, D.C., and at its regional offices in New York City and Chicago from April 1981 until January 1982. During this time, we met with and briefed staff of the House Committee on Agriculture and Senate Committee on Agriculture, Nutrition and Forestry as well as staff of the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, and the Commerce, Consumer and Monetary Affairs Subcommittee, House Committee on Government Operations. We also coordinated our work with other congressional agencies, including the Congressional Research Service, Congressional Budget Office, and Office of Technology Assessment.

CHAPTER 2

FEDERAL PROGRAMS REGULATING COMMODITY FUTURES TRADING SHOULD BE REAUTHORIZED

The sunset feature in CFTC's enabling legislation requires CFTC to be reauthorized by the Congress or to suspend operations and cease to exist. CFTC's current authorization expires at the end of September 1982. The rapid growth in futures trading, its increasingly important role in the Nation's economy, and recent events in commodities markets underline the continuing need for Federal regulatory programs to maintain public confidence in the operation and integrity of futures markets. These programs include: approval of standardized contracts for futures trading, surveillance of futures markets, registration of industry professionals, audit and financial surveillance of futures commission merchants, oversight of exchange rule enforcement, and resolution of customer claims.

Although we found weaknesses in certain CFTC operations, we believe the Federal commodity regulatory programs administered by CFTC should be reauthorized to provide the direct regulation and regulatory oversight that is essential if the full benefits of futures trading are to be realized and the rights of futures market participants adequately protected. Since our 1978 review of CFTC, the agency, under three successive chairmen, has made notable progress in (1) overcoming initial organizational difficulties, (2) improving overall management and direction, and (3) developing comprehensive commodity futures regulation. We believe that, building on the substantial progress and achievements realized in the past 7 years, the Federal Government can continue to review and refine its regulatory role and, in effective partnership with the commodity futures industry, can construct a regulatory framework combining appropriate Federal regulation and oversight with responsible self-regulation by the futures industry.

WHY FEDERAL REGULATION OF FUTURES TRADING NEEDS TO BE REAUTHORIZED

In our May 17, 1978, report issued in conjunction with the first sunset review of CFTC, we concluded that the need for an independent regulatory commission for futures trading and the wisdom of the Congress in creating such a body had been amply demonstrated by the continued rapid growth and diversification of the futures industry in the years since CFTC was created. We concluded in 1978 that the increasingly important role played by futures trading in the national economy, combined with the potential for harm in the manipulation or disruption of futures markets, called for regulatory oversight by a strong, independent agency, free of built-in conflicts of interest such as those in the Commodity Exchange Authority, Department of Agriculture. Our recommendation in 1978 was that CFTC be reauthorized for 4 years. The Congress adopted this recommendation and, as a result, CFTC was authorized appropriations through fiscal year 1982.

Our current review, as well as developments within the futures industry since 1978, convince us that an increasing need exists for the regulatory programs administered by CFTC and for strengthened self-regulation by the Nation's commodity exchanges and other industry institutions.

Program accomplishments since 1975

Since it began operating in 1975, CFTC has made considerable progress in implementing the broad mandate and new powers conferred upon it by the amendments of 1974. CFTC has developed programs and promulgated new rules and regulations in such diverse areas as

- registration of commodity professionals,
- procedures for exchange disciplinary actions and CFTC review of these actions,
- regulation of leverage transactions and commodity options,
- imposition of limits on speculative futures positions,
- customer protection,
- minimum capital and other financial requirements for futures commission merchants (FCMs), and
- arbitration of disputes arising out of transactions executed on commodity exchanges.

Through an enforcement program, CFTC has tried, and succeeded to a great extent, to instill respect among industry participants for regulatory requirements and to achieve compliance with those requirements. In fiscal year 1981 alone CFTC imposed the largest civil penalty in its history (for violation of speculative position requirements) as well as the largest civil penalty ever assessed against a commodity exchange for failure to fulfill its self-regulatory responsibilities under the act and CFTC regulations.

CFTC has recently taken an important step toward achieving an effective regulatory partnership with the commodities industry by approving the registration of the National Futures Association (NFA) as an industry self-regulatory association. NFA, as well as other self-regulatory associations that CFTC may approve in the future, can help CFTC to streamline, focus, and refine its regulatory role by assuming regulatory functions (such as registering commodity professionals) that can be safely and efficiently performed by private self-regulatory groups.

Recently, consistent with the current emphasis on fiscal restraint and reduction of regulatory burdens, CFTC has proposed eliminating redundant reporting requirements that have imposed a nonessential burden on the futures industry and an unnecessary strain on CFTC's resources.

FEDERAL COMMODITY REGULATORY PROGRAMS SHOULD BE REAUTHORIZED

The 1974 act that created CFTC authorized it only through fiscal year 1978. At the end of fiscal year 1978, in line with our recommendation, the Congress authorized CFTC appropriations for an additional 4 years. We believe the programs administered by CFTC must again be reauthorized.

Despite the need for a strong regulatory presence in futures trading, CFTC, no less than other Federal agencies and departments, has had to contend with resource and staffing limits that severely circumscribe its ability to initiate new regulatory programs and challenge it to make the most effective and efficient use of its resources. In fact, as a relatively new Federal agency and one whose funding and staffing levels have remained comparatively constant since its creation in 1975 (see app. IV), CFTC is hard pressed to reconcile its broad regulatory mandate with a tight budget. Although this situation might be viewed as an insoluble problem for the agency, we see it as offering a challenge and an opportunity for the Federal Government to redefine its regulatory role and place greater emphasis on the concept of supervised industry self-regulation, which is already prominent in CFTC's governing statute.

CONCLUSIONS

Commodity futures markets continue to play an important role in the Nation's economy. Because of this role, futures trading should be regulated by a strong, independent agency that can ensure public confidence in the operation and integrity of futures markets. Federal commodity regulatory programs should be reauthorized to ensure the continuation of regulatory safeguards. CFTC has developed new rules and regulations designed to better protect trading customers. At the same time, CFTC has increased its enforcement effort to gain compliance with these rules and regulations. CFTC still faces considerable challenges as it refocuses its regulatory role to place increased reliance on and assume greater oversight of industry self-regulation. Reauthorization of Federal regulatory programs will provide an opportunity for the changes and improvements in these programs that we suggest in our report, while providing the Congress with an appropriate benchmark to assess progress.

RECOMMENDATION TO THE CONGRESS

We recommend that the Congress reauthorize the existing Federal commodity regulatory programs.

CHAPTER 3

CFTC's CONTRACT APPROVAL AND REVIEW PROCESS CAN BE IMPROVED

For each commodity it wishes to trade, a commodity exchange develops and submits for CFTC's approval a standardized contract tailored to trading the particular commodity. CFTC conducts a detailed economic review of the proposed contract to determine if it is likely to be useful to businesses in managing the risks of commodity ownership. Since our 1978 review, CFTC has improved its process for reviewing and approving proposed contracts. However, CFTC could further refine its procedures for approving contracts, and revise the criteria it uses to judge contracts. These improvements are needed to minimize delays in approval of contracts and to avoid the approval of deficient contracts.

Once a contract begins trading, the Commodity Exchange Act requires that it continue to meet contract approval requirements. Despite this requirement, CFTC has focused its resources on reviewing proposed contracts instead of reviewing existing contracts, thus increasing the potential for market distortions. To prevent potential distortions, CFTC needs to devote more attention to reviewing existing contracts.

Through contract approvals, CFTC, in effect, licenses an exchange to carry on a business activity. This licensing activity falls within Office of Management and Budget guidance on when fees should be charged for Government services. By charging such fees, CFTC could recover the costs of approving proposed contracts.

CFTC CAN REFINE ITS PROCESS FOR APPROVING FUTURES CONTRACTS

The standardized contract an exchange submits to CFTC for approval specifies, among other things, the quantity of the commodity to be delivered; the grades of the commodity, including alternate grades that may be delivered at a premium or discount; and where the commodity will be delivered. For a commodity exchange to receive approval to trade standardized contracts in a particular commodity, that is, to be designated as a "contract market" pursuant to section 6 of the act, it must meet the standards in section 5. In particular, section 5(g), added to the act in 1974, requires CFTC to approve contracts only when exchanges demonstrate that trading in the proposed contract "will not be contrary to the public interest."

In its Guideline I 1/ CFTC stipulates that exchanges wishing to receive approval to trade contracts in particular commodities must (1) demonstrate that a proposed contract meets the test of economic purpose, (2) establish that the contract terms and conditions are written so that the contract is likely to be useful to market participants and is not conducive to price manipulation or distortion, and (3) affirm that trading in the contract will not be contrary to the public interest.

CFTC's Division of Economics and Education reviews proposed contracts for compliance with these economic requirements. The division's analysis section, which is divided into three units--natural resources, financial instruments, and agricultural commodities--evaluates a proposed contract's conformance with Guideline I and also reviews approved contracts to assure continued compliance with these requirements.

Demonstrating economic purpose--CFTC can perform a more complete analysis

CFTC can more thoroughly and systematically analyze whether a proposed contract complies with approval requirements. CFTC needs to better verify the information submitted by exchanges. Further, CFTC needs to systematically identify knowledgeable sources with whom to discuss proposed contracts.

As noted in chapter 1, futures contracts can serve an economic purpose in two possible ways--price discovery and/or hedging. To demonstrate that a proposed contract serves an economic purpose, Guideline I requires that an exchange furnish evidence that (1) the prices discovered in trading the proposed contract will be disseminated to commercial producers and users who may use these futures prices to establish cash market prices or (2) commercial producers and/or users are likely to use the contract for hedging purposes. CFTC also requires that an exchange establish that "something more than occasional use of the contract" can reasonably be expected to exist.

To demonstrate a contract's economic purpose, exchanges typically supply several kinds of evidence. When a contract is expected to serve a price-basing purpose, the exchange must demonstrate how the prices discovered in futures trading will be quoted and disseminated to help establish cash market prices. When a contract is expected to serve a hedging purpose, the exchange must submit examples showing how the contract might be used for hedging

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1/Guideline I, adopted in 1975 as a CFTC policy statement, describes the information exchanges must submit to receive approval of proposed contracts and may be called upon to submit to justify continued trading in an existing contract.

purposes and letters from commercial producers and/or users who, as potential hedgers, express support for the proposed contract. The exchange contacts these potential hedgers when designing a contract to obtain their views on how the contract should be fashioned to make it a useful hedging tool.

To analyze the economic purpose of proposed contracts, analysis section economists review the exchange-provided information, gather cash-market data on the commodity, and interview potential hedgers who have written letters supporting the contract and other potential hedgers whom they independently identify. Through their analysis, CFTC economists try to determine whether potential hedgers show interest in using the contract for hedging purposes.

During our 1978 review, we examined selected CFTC contract approvals and found that the exchanges proposing these contracts had not submitted enough evidence to demonstrate that the contracts could reasonably be expected to be used for pricing or hedging. We concluded that CFTC needed to better explain the type and quantity of evidence exchanges must provide to satisfy the requirements of the economic purpose test.

During this review, we examined 10 contracts (listed in app. VIII) to determine how CFTC currently applies the economic purpose test. Our criteria for selecting contracts considered various exchange and commodity characteristics. We considered exchange trading volume and geographical location and included commodities from the financial instruments, agricultural products, and natural resources groups. Many financial instruments appear in our selection because they are the fastest growing commodity group.

Although CFTC has not made its standards for evidence any more specific, we did find that exchanges are submitting more support of the contract's economic purpose. In particular, for the 10 contract applications we evaluated, an average of five potential hedgers had submitted letters on the exchange's behalf supporting the proposed contract.

In determining economic purpose, CFTC contacts only a few of the potential hedgers whose statements the exchanges submit as demonstration of economic purpose. For the 10 contracts we reviewed, the analysis economists contacted, on average, only one of these potential hedgers--a verification rate of only 20 percent. According to the Economics and Education Division associate director, analysis section economists do not contact more of the potential hedgers whose statements are submitted because they believe their time is better spent interviewing potential hedgers other than those recommended by the exchange.

CFTC needs to contact more potential hedgers whose statements are submitted. CFTC relies heavily on statements of hedging interest as a primary source of evidence to demonstrate a contract's likely economic purpose and the exchange uses hedgers' views in designing the contract. When an exchange submits a modest number of statements (five is the average number CFTC currently receives), CFTC could contact all the potential hedgers without adding considerably to the review process. If many statements are submitted, CFTC could contact a representative sample of potential hedgers. Unless CFTC contacts at least a representative sample of the hedgers purported to support a proposed contract, CFTC is accepting these statements as evidence that a contract serves an economic purpose without investigating the validity of these statements.

This contact could also include a detailed discussion of the potential hedger's expected use of the contract, his or her views on the contract's terms and conditions, and his or her involvement in the cash market for the underlying commodity. This discussion would allow CFTC to gauge the significance of the potential hedger's support. When we discussed procedures for evaluating a contract's likely economic purpose with the former Chairman, he acknowledged that potential hedgers' statements are of little value unless CFTC also interviews these parties.

CFTC also contacts potential hedgers other than those the exchange identifies. This contact is important since CFTC needs to ensure that all interests are represented, especially potential hedgers who may not have participated in developing the proposed contract. We found that CFTC's analysis economists use a variety of _ad hoc_ procedures to identify additional contacts. These procedures can include (1) researching the cash market in CFTC's library, (2) occasionally contacting CFTC's surveillance economists for suggestions, (3) contacting individuals they have dealt with on previous reviews of similar contracts, and (4) looking in the telephone company's Yellow Pages for firms doing cash market business. CFTC analysis economists support such _ad hoc_ procedures on the grounds that the approach for gathering contacts cannot be standardized. However, regardless of the underlying commodity, economists analyzing futures contracts have a common goal--to interview industry sources who are knowledgeable about the commodity. Therefore, we believe a more systematic approach for identifying knowledgeable sources would help assure that the division systematically considers varying interests. CFTC needs to adopt a more systematic approach to better judge whether a contract will serve an economic purpose and to make the contract more useful to commercial interests.

One way to help identify knowledgeable potential hedgers would be to regularly involve surveillance economists. [1] To be effective in their work, surveillance economists must become familiar with key market participants in both cash and futures markets. Surveillance economists could therefore help analysis economists by sharing this information. At present, surveillance economists are not routinely involved in the contract approval process.

CFTC review of contract terms and conditions has improved

Properly drafted contract terms and conditions (1) help reduce the potential for manipulation, congestion, or control and (2) provide greater hedging and pricing benefits in trading the contract. To promote these results, terms and conditions need to mirror the marketing pattern of the cash commodity underlying the futures contract as closely as practicable. The only appropriate deviations are those that are necessary or desirable for viable futures trading.

Recognizing the importance of well-drawn contract terms and conditions, CFTC requires that an exchange justify the individual contract terms and conditions it has proposed. To do so, the exchange must submit information, including economic data or the statements of market experts, which demonstrates that (1) each term or condition conforms to normal commercial practices or, if not in conformity, is necessary or desirable to carry out the contract's pricing or hedging function and (2) contract terms and conditions, as a whole, provide for a deliverable supply that is not conducive to price manipulation or distortion.

Our 1978 review showed that CFTC had not conducted an adequate review of the terms and conditions of existing contracts that came under its jurisdiction in 1975. We recommended that CFTC resolve outstanding questions pertaining to these contracts. CFTC Economics and Education Division officials told us that the problems with these contracts' terms and conditions had been resolved.

In this review, we found that CFTC has improved its review of contract terms and conditions. For example, in the 10 contracts we examined, analysis economists discussed the terms and conditions of each proposed contract with an average of eight officials of firms who use or produce the commodity. These included officials whose support the exchanges had solicited as well as officials CFTC independently contacted. The economists tried to gain a consensus among informed parties regarding whether the terms and conditions of the proposed contract would be useful to potential hedgers and whether the contract might adversely affect the cash market. The economists also solicited suggestions from the industry sources as to how the contract terms could be revised to enhance the contract's potential economic purpose.

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[1] The role of CFTC surveillance economists is discussed in ch. 4.

CFTC's emphasis on terms and conditions also provides important support for the economic purpose test. The Director and Deputy Director, Economics and Education Division, stressed to us that terms and conditions that closely mirror the cash market increase the potential for hedger interest and thus the likelihood that the contract will serve an economic purpose.

Affirmation of public interest needs better standards

CFTC's final requirement for contract approval is that the exchange affirm that futures transactions in the commodity to be traded are not, or are not reasonably expected to be, contrary to the public interest. This requirement is intended to fulfill the act's mandate that CFTC approve a contract only when the sponsoring exchange demonstrates that trading in the proposed contract "will not be contrary to the public interest." In our 1978 review, we expressed reservations about whether CFTC's affirmation requirement fulfills the act's mandate and recommended that CFTC consider developing a more meaningful public interest test.

Our current review found the situation essentially unchanged. For the 10 contracts we reviewed, we found that in 9 cases the exchanges merely affirmed that the proposed contracts would not be contrary to the public interest. One exchange did go beyond this perfunctory affirmation, explaining that it had considered the views of cash market participants and the general public in designing the contract so that the contract would facilitate equitable futures trading and be compatible with the cash market.

We discussed our observations with CFTC officials. The Director, Economics and Education Division, and his predecessor told us that the public interest test lacks standards. Similarly, the associate director, analysis section, told us that the agency has no criteria to apply in judging a contract's likely effect on the public interest.

Comments we received from exchange officials revealed varying interpretations of the public interest test requirements. For example, while a New York Mercantile Exchange vice president stated that the economic purpose test and public interest test are the same, a Chicago Mercantile Exchange vice president told us that the public interest test requires only sound contract terms and conditions. A Commodity Exchange, Inc., vice president stated that he had no idea what the public interest test means.

Although defining precisely what constitutes the public interest is difficult, contract approval needs to be based on clear standards that are meaningful to CFTC and the exchanges. Because the public interest test now consists of only affirmation, it might reasonably be asked, as it was by the former Chairman, how anyone could expect an exchange that is proposing a contract to do other than make this affirmation. Without substantive standards for the public interest test, we question the value of this aspect of the contract approval process.

CFTC's proposed revision to Guideline I would provide better approval criteria

In October 1980 CFTC proposed revisions to Guideline I to provide exchanges with more specific criteria and a more uniform procedural framework to use in demonstrating compliance with the act. The proposed revisions would (1) require exchanges to provide additional information to demonstrate economic purpose and adequate contract terms and conditions and (2) clarify the meaning of the public interest test. In proposing the rules, CFTC noted that exchanges have not uniformly carried out the evidentiary burden placed on them by section 5(g) and that exchange applications have not consistently demonstrated compliance of individual contract terms and conditions with sections 5 and 5a of the act.

The proposed revisions would more closely link the economic purpose test and the justification of contract terms and conditions. For example, to provide a framework for justifying contract terms and conditions, an exchange would have to submit a comprehensive analysis of the underlying cash market. Based on this analysis, the exchange would then be required to justify each contract term and condition, as required under the existing Guideline I. The exchanges would also be required to explain why each term or condition was selected and how that term or condition supports price basing or hedging.

To pass the economic purpose test, the exchange would still have to meet the existing Guideline I requirements for hedging or price basing. To do so, however, the exchange would have to draw together the cash market and contract terms data to demonstrate that it is reasonable to expect the contract to be used for hedging and/or price basing. As evidence, the exchange would, as required under Guideline I, provide statements or reports of interviews with potential contract users that would convey "specifically the manner and circumstances under which these persons may be expected to utilize the contract for pricing or hedging."

The proposed changes would also clarify and strengthen the public interest test. Rather than provide a routine affirmation that the contract would not be contrary to the public interest, under the proposed revisions, exchanges would have to closely tie satisfaction of the public interest test to compliance with CFTC Regulation 1.51 and Guideline II. 1/ In particular, an exchange proposing a new contract would have to demonstrate the efficacy of its rule enforcement program and describe any changes introduced since CFTC's last rule enforcement review. In addition, an exchange would have to describe those specific rule enforcement programs adopted to address unique problems raised by the proposed futures contract. Finally, an exchange would have to demonstrate that a flexible surveillance program was in place to deal effectively with the proposed futures contract.

We discussed the proposed Guideline I revisions with CFTC officials. Both the present Chairman and his predecessor told us that the revisions are appropriate. The former Chairman, still a Commissioner, further stated that the revisions would make Guideline I clearer, more specific, and more rigorous in its economic purpose standards. The Director, Economics and Education Division, told us that he believes the proposed revisions would endow the public interest test with specific requirements. The division's Deputy Director supported the revisions because he believes more specific guidelines will encourage exchanges to submit all information necessary for approval, making it unnecessary for CFTC to request additional information.

Despite CFTC officials' support for the proposed Guideline I revisions, CFTC has not acted on them. When we asked why CFTC had not approved the proposed revisions, the Economics and Education Division Director stated that scarce division resources had slowed agency action on the matter. According to a May 1982 CFTC news release, the agency plans action on the proposed revisions during the spring or summer of 1982.

CFTC NEEDS TO DEVOTE MORE ATTENTION TO EXISTING CONTRACTS

After a contract has been approved, it must continue to satisfy the initial approval criteria in section 5 of the act. It must also comply with the additional requirements in section 5a. Consequently, Guideline I requirements also apply to contracts after they begin trading. CFTC Regulation 1.50 explains the agency's power to review existing contracts. CFTC, however, has focused most of its attention on approving new

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1/CFTC Regulation 1.51 and Guideline II, which require exchanges to maintain an effective rule enforcement program, are discussed in detail in ch. 7.

contracts and has devoted little attention to reviewing existing ones. To assure that existing contracts are fulfilling the act's requirements, we believe CFTC needs to balance its contract reviews by giving more attention to existing contracts.

CFTC has reviewed few existing contracts

Existing contracts are reviewed for two reasons. First, establishing that a contract will serve an economic purpose before trading begins is difficult. Only when the contract is actually traded will the extent of hedging and/or pricing use be known. Second, since cash markets continue to evolve after the futures contract begins trading, contract terms and conditions may eventually differ from the cash market--that is, cash market delivery points may shift away from those specified in the contract. If these differences become too great, the potential for market disruption increases and the hedging and pricing functions of the contract may be impaired.

During our 1978 review we found that CFTC did little review of existing contracts. Rather, CFTC waited for exchanges to submit proposed contract changes for its approval. Reviewing existing contracts had been given a lower priority than reviewing applications for new trading instruments. We recommended that CFTC establish a program to monitor how well exchanges were carrying out their responsibility to ensure that contracts reflect changing market conditions.

In its formal response to our recommendation, CFTC recognized that periodic reviews of existing contracts were important to prevent price distortion and diminished economic purpose in existing futures contracts. CFTC stated that as resources permitted it would use Regulation 1.50 to review existing contracts. Since 1978, however, CFTC has made less and less use of its Regulation 1.50 provision. The regulation, as originally written in 1975, required that, for each existing contract, the sponsoring exchange demonstrate once every 5 years the contract's continued compliance with contract approval requirements. The Director and Associate Director of the Economics and Education Division told us that they found that this automatic review process led the agency to review contracts that were clearly trouble-free and economically useful. Accordingly, in April 1978, CFTC revised Regulation 1.50 to make reviewing existing contracts a matter of agency discretion. In proposing the revisions, CFTC stated that, although reviewing problematic contracts would receive highest priority, the agency would also "review periodically as many contracts as its resources permit."

As the table below shows, 1.50 reviews have decreased dramatically--only two reviews were initiated in 1980 and none in 1981. Further, in fiscal year 1981, the analysis section devoted only 5 percent of its contract review time to reviewing existing contracts. It spent most (67 percent) of its contract review time on new contract approvals and 28 percent of its contract review time on exchange-initiated changes to contracts.

Reviews of Existing Contracts
Initiated Under Revised Regulation 1.50

(calendar years)			
1978 (note a)	1979	1980	1981
N.Y. Mercantile Exchange Maine round white potatoes	Chicago Mercantile Exchange 1-year Treasury bills	Chicago Mercantile Exchange 90-day Treasury bills	No reviews initiated
N.Y. Cocoa Exchange cocoa	Chicago Board of Trade Government National Mortgage Association Collateralized Depositary Receipts	N.Y. Cotton Exchange cotton #2	
N.Y. Coffee and Sugar Exchange coffee "C"	Chicago Mercantile Exchange frozen pork bellies		
Chicago Mercantile Exchange frozen pork bellies	N.Y. Cotton Exchange cotton #2		

a/These reviews were initiated after Regulation 1.50 was revised in April 1978.

Source: Economics and Education Division

Reviews of existing contracts have not focused on economic purpose

We reviewed the Regulation 1.50 reviews CFTC has initiated under the revised rule and found that in 9 out of 10 cases the only specific information CFTC requested pertained to contract terms and conditions. In the 10th case, CFTC made a broad request that the exchange demonstrate that a contract complied with the Guideline I economic purpose and public interest requirements. The associate director, analysis section, confirmed that 1.50 reviews performed under the revised rules have focused on contract terms and conditions and have not involved investigating economic purpose. We believe this situation arises because the analysis section has relied on the surveillance unit to identify contracts needing a 1.50 review. [1] According to the associate director, analysis section, when CFTC revised the 1.50 process, the agency adopted an approach geared to analyzing problems the surveillance unit identified.

Despite the reduced effort devoted to reviewing existing contracts, CFTC officials support the Regulation 1.50 review process. The Chairman told us that since it is difficult to evaluate a contract's economic purpose before CFTC approves it, CFTC should use Regulation 1.50 to examine a contract's economic purpose after it has been trading. Further, the Chairman believed that reviewing existing contracts is the only way CFTC can determine whether a contract's terms and conditions continue to conform to the cash market. The Economics and Education Division's Director told us that reviews of existing contracts allow CFTC to determine whether a contract has potential problems that could impair orderly trading. The Director also said that the division would do more 1.50 reviews if it had more resources.

CFTC justified its Regulation 1.50 revision as an attempt to make reviews of existing contracts more flexible, focused, and efficient. We believe, however, that the decrease in reviews indicates that CFTC has used the revision not to fashion a more efficient and effective review process but rather to deemphasize reviewing existing contracts and to concentrate on approving new contracts.

CFTC needs to revise requirements and procedures regarding existing contracts

CFTC's proposed Guideline I revisions give CFTC an opportunity to determine whether a contract is serving an economic purpose. In particular, to show its continuing compliance with the Guideline I economic purpose requirement, an exchange would have to demonstrate that trading in the contract had, in fact, served (and continues to serve) a hedging or price-basing function on more than an occasional basis. This demonstration would include evaluating (1) the actual commercial and price-basing use of the contract and (2) the extent to which commercial participation in the contract actually constituted hedging.

One way to provide more resources to review existing contracts would be to more fully involve surveillance economists. Surveillance economists' identification of the divergence of a contract's terms and conditions from the cash market plays an important role in developing a Regulation 1.50 review. Consequently, the surveillance economist is in an excellent position to evaluate the exchange's response to the 1.50 review. Surveillance economists have occasionally been involved in 1.50 reviews but not consistently. For example, a Chicago surveillance economist did review a proposed change in the types of lumber deliverable under the Chicago Mercantile Exchange's random lumber contract. A New York surveillance economist, on the other hand, although developing the recommendation for a 1.50 review of the New York Cotton Exchange's cotton contract, did not participate in reviewing the exchange's response. Most surveillance economists have not participated in these reviews. The Director, Market Surveillance, and the economists in charge of surveillance in New York and Chicago agreed that opportunities exist to more fully use surveillance economists' expertise in other CFTC activities such as reviewing existing contracts.

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[1] The surveillance unit monitors contracts to determine whether any contract's terms are open to manipulation.

Review of dormant and low-volume contracts could be handled by adopting proposed rules

Not all futures contracts that CFTC approves are successfully traded. Some contracts achieve only a low volume of trading or fall dormant and do not trade at all. These existing low-volume and dormant contracts have the potential to not comply with the Guideline I economic requirements. In low-volume contracts, trade practice abuses such as noncompetitive and prearranged trades are more likely to occur than in active markets, increasing the possibility that the prices discovered may be inaccurate, artificial, or misleading. For example, trading abuses occurred in two New York Mercantile Exchange low-volume contracts. Further, because of their low trading volume, these contracts are not particularly useful for hedging purposes. Similarly, dormant contracts, because they involve no trading, fail by definition to serve a hedging or price-basing function.

In October 1980 CFTC proposed rules that would address the problems arising in low-volume and dormant contracts. For low-volume contracts, exchanges would have to file periodic reports on those contracts falling below a CFTC-imposed threshold of trading activity. These reports would include an analysis of trading activity, commercial use of the contract, and exchange surveillance of trade practices. For contracts that, after an initial start-up period, have no trading activity for 1 month (dormant contracts), CFTC would require exchanges to receive CFTC approval before further trading of the contract would be allowed. Before such contracts could be traded again, exchanges would have to notify CFTC and justify reopening trade of the contract.

The proposed rules would provide an alternative that requires less resources than 1.50 reviews to control contracts that may not serve an economic purpose. CFTC, however, has not acted on the proposed rules. CFTC's January 1982 budget planning document stated that the Economics and Education Division had not given highest priority to drafting final rules on dormant and low-volume contracts. According to a May 1982 CFTC news release, during the spring of 1982 CFTC will act on rules dealing with dormant and low-volume contracts.

IMPROVED ADMINISTRATIVE PROCEDURES COULD REDUCE THE TIME NEEDED FOR CONTRACT APPROVAL

While CFTC needs to thoroughly evaluate a proposed contract it also needs to approve contracts quickly and efficiently so that economically valuable contracts can be traded as soon as possible. Since 1978, however, the time required for CFTC approval has lengthened. Several factors have increased the time needed to approve contracts: expanded contract reviews (discussed previously), complex policy issues, exchange unresponsiveness, and CFTC administrative procedures.

During our review, CFTC took action to streamline the contract approval process. In fact, CFTC approved 20 contracts during the last half of 1981. However, we believe CFTC's contract approval process can be further streamlined.

Since our 1978 report, the average number of months required for contract approval has increased--from 9.3 months in fiscal year 1978 to 17.8 months in fiscal year 1981. (See the following table.) The backlog in pending contracts reached 42 at the end of fiscal year 1981.

Status of Contract Applications

	FY 1978 (note a)	FY 1979	FY 1980	FY 1981
Proposed contracts received	11	18	30	17
Total contracts to be processed (including carryover from previous year)	20	30	55	57
Contracts approved	8	5	11	15
Contracts pending at end of year	12	25	b/ 40	42
Average time for approval (months)	9.3	12.8	14.7	17.8

a/At the end of fiscal year 1977 nine contracts were pending.

b/Excludes four American Commodity Exchange contracts that were pending when the Exchange closed in 1980.

Source: Economics and Education Division.

Lengthy contract approval periods can have a negative economic effect. Since contracts allow commercial interests to shift their cash market risks (and thus lower their costs), individual firms' and aggregate industry costs are kept unnecessarily high when contracts are not available for trading as soon as practicable. This situation also results in higher costs to the public because economic theory assumes that firms will pass on cost savings in the form of lower prices charged for their goods and services.

Difficult policy issues and exchange unresponsiveness have contributed to the length of time needed to approve new contracts

While some of the factors lengthening the contract approval period stem from CFTC administrative procedures, the large number and controversial nature of the contracts CFTC has had to consider, as well as the actions of other Federal agencies and the exchanges, also have affected the contract backlog.

Since 1978 CFTC has received 76 contract proposals. Of these, 74 percent were contracts based on financial instruments such as Government securities, domestic and Eurodollar certificates of deposits, and stock indices. These financial instrument contract proposals have raised complex policy issues and required CFTC to coordinate with other Federal agencies. For instance, CFTC and the Securities and Exchange Commission disagreed about which agency should have jurisdiction over stock index futures. Although the first stock index contract was submitted in June 1979, the two agencies did not resolve their differences until December 1981. Further, section 2(a)(8)(B)(ii) of the act requires CFTC to consider Federal Reserve Board and Treasury comments on proposed contracts based on any U.S. Government security. Beginning in 1978, these agencies raised several questions relating to the potential impact of financial futures on the Government securities market. While these important policy issues and jurisdictional questions certainly warranted the time required for their consideration, they have slowed the contract approval process.

The level of exchange responsiveness to CFTC has also affected the rate of contract approval. The Economics and Education Division's Deputy Director and several division economists have stated that the exchanges have contributed to the backlog by slow responses to CFTC requests for information regarding contract submissions. For 3 of the 10 contracts we examined, exchange replies were slow--with response times ranging from 3 months to more than a year.

According to the division's Deputy Director, in the rush to get a place in the contract approval line, exchanges have submitted contracts before they were fully developed. In other cases, according to the Deputy Director, exchanges have simply copied a competitor's contract and submitted it. The Deputy Director stated that when CFTC requested additional information on these contracts, the exchanges either had difficulty developing the information or assigned a low priority to formulating a response. Exchange officials we spoke with disagreed with this assessment. For instance, a MidAmerica Commodity Exchange vice president stated that his exchange does not submit contract applications to CFTC until they conform to Guideline I. A

Chicago Board of Trade official charged with developing agricultural futures stated that it takes the exchange a lot of time and resources to answer CFTC's queries.

Whatever the reason for exchange unresponsiveness, CFTC's new Chairman considered the problem serious enough to inform the exchanges in September 1981 that failure to answer CFTC correspondence regarding a proposed contract within 90 days will result in withdrawal of the contract from the approval process.

Improved administrative procedures could strengthen the approval process

One problem affecting contract approval is that documentation of a contract's likely economic purpose arrives at CFTC sporadically and often late. For 6 of the 10 contracts we evaluated, the letters CFTC received from individual potential hedgers arrived from 1 to 12 months after the exchange's initial submission. According to exchange officials, these delays occur because although the exchange interviews potential hedgers to solicit their support of a contract long before its submission to CFTC, the potential hedgers characteristically procrastinate in writing letters of support. Because CFTC uses these letters to document economic purpose, their late arrival means that an important component of CFTC's analysis is not available to economists when they begin their work, and thus the approval process is delayed.

An alternative to using potential hedgers' letters to demonstrate economic purpose would be to use the interviews exchanges conduct with potential hedgers. Since these interviews are conducted before the contract is submitted, we believe including records of these interviews would be a relatively simple way to provide this information when the contract is submitted. The associate director, analysis section, told us that, in fact, CFTC allows exchanges to use this approach. Nevertheless, we found that in 9 of the 10 contracts we reviewed, CFTC still relied on potential hedger's letters as the primary evidence of the contract's likely economic purpose.

Another problem with CFTC administrative procedures is that the Economics and Education Division inconsistently applies deadlines to staff work. The associate director, analysis section, told us that the economists' contract analysis is not subject to target dates. Without a consistent policy on deadlines, staff supervisors took varied approaches to establishing them. The head of the financial instruments unit told us that he tries to informally establish a deadline with the economist assigned to analyze the contract. The head of the agriculture unit stated that he sets a deadline toward the end of the economist's analysis. The natural resources unit head reported that once a contract's major problems are resolved, he and the economist may set a deadline for completing the analysis.

Our discussions with the analysis economists resulted in equally varied statements about deadlines. One economist stated that although his work is under no time limit, toward the completion of his analysis his supervisor usually discusses deadlines with him. According to another economist, who described the division's review process as "open-ended," the division does not use staff deadlines.

We discussed the division's inconsistent application of deadlines with CFTC's Chairman in September 1981. He told us that he believed deadlines were appropriate and expressed surprise that division staff were not consistently required to meet deadlines. He promised to discuss the matter with the division's Director. In a subsequent interview, the Director, Economics and Education Division, stated that economists do work under deadlines agreed upon by the economist and his or her supervisor when analysis begins.

Although, according to the Division Director, staff work is now subject to deadlines, we believe the varying statements from staff members demonstrate that deadlines are used inconsistently. Moreover, according to the Division Director, these deadlines are oral agreements between economist and supervisor; staff work is still not subject to formal deadlines, which would provide control and accountability.

The order in which staff review a proposed contract can also slow contract approval. When a contract arrives at CFTC, it is forwarded to the Economics and Education Division where the unit head assigns it to an economist for analysis. After several months of analysis, the economist and his or her unit head develop a report on the contract and forward it for final evaluation to the associate director, analysis section, and the division's Deputy Director. These officials, who have considerable expertise in commodity futures, review the contract submission for potential problems.

Delays in contract approval often occur when these officials identify issues that warrant further study. According to the head of the agricultural unit, these senior level final reviews always result in the need to gather additional information. For example, in one case, although the head of the financial unit had previously advised an exchange that division recommendation for approval would be forthcoming, the Deputy Director subsequently questioned the contract's economic purpose, delaying approval by several weeks. In another case, an economist and his unit head forwarded their analysis to the Deputy Director, believing that they had resolved all contract problems. However, the Deputy Director's review identified a problem that delayed the contract's approval by 3 months.

A former Director, Economics and Education Division, told us that the order in which the division staff currently reviews contracts is "backwards." He stated that senior level staff should review the contract before passing it on to an economist. Similarly, the division's Deputy Director acknowledged the delays that result from the current procedure. The associate director, analysis section, also told us that initial senior level review of contracts would be more appropriate.

During our review, we noted other administrative procedures associated with reviewing proposed contracts that could be streamlined. In particular we noted the following:

--Publishing contracts in the Federal Register for public comment, a legislatively required task, occurred as much as 9 months after contract submission. Consequently, economists evaluating the contracts did not have the benefit of public comments until late in their analysis.

--The contract review of the Economics and Education Division and the Trading and Markets Division 1/ was successive: the Economics and Education Division finalized its recommendations before forwarding them for the Trading and Markets Division's consideration. This added up to 5 weeks to the approval process.

--The Trading and Markets Division's recommendation memorandum to the Commission often repeated much of the information the Economics and Education Division included in its recommendations. This reiteration and summarization added several weeks to the approval process.

During our review, we discussed these observations with CFTC officials. Subsequently, CFTC took the following actions:

--In November 1981 CFTC gave sole responsibility for Federal Register publication of proposed contracts to the Economics and Education Division in order to eliminate the delays which had resulted from involving both the Economics and Education and the Trading and Markets Divisions in this task.

--In October 1981 CFTC revised its procedures so that the Economics and Education Division makes its draft recommendations available to the Trading and Markets Division. This allows the two divisions to forward their recommendations simultaneously to the Commission.

1/The Division of Trading and Markets reviews the application for contract approval to determine whether it demonstrates that the exchange's staff and procedures are sufficient to regulate trading of the proposed contract.

--In October 1981 CFTC revised its procedures so that the Trading and Markets Division is given an opportunity to concur with the Economics and Education Division's recommendations rather than repeating them in its memo to the Commission.

EXCHANGES SHOULD BE ASSESSED USER CHARGES FOR CONTRACT APPROVAL

CFTC's contract approval process provides an excellent opportunity for implementing a user charge. Licensing an exchange to trade a contract falls within policy guidance provided by the Office of Management and Budget on when fees should be charged for Government services. In designing a user charge, CFTC needs to consider its own fee authority and other decisions by the Congress and the courts.

The term user charge refers to any charge collected from recipients of Government goods, services, or other benefits not shared by the public. This definition includes fees collected to offset the costs of privileges supplied by the Government. User charges are authorized either by specific legislation or by the general authority granted to Federal agencies in the User Charge Statute--Title V of the Independent Offices Appropriation Act, 1952 (31 U.S.C. 483a). A series of court decisions has limited agency authority to assess fees. 1/ In particular, an agency may charge no more than the direct and indirect costs it incurs in providing a special benefit to the recipient. It may not charge for costs attributable to benefits to the public. It must also only charge specific identified recipients of the Government benefit. Although these decisions arose under the User Charge Statute, the courts' reasoning appears to apply to any statute permitting an agency to assess fees. 2/

In section 26 of the Futures Trading Act of 1978 the Congress stated that CFTC may develop and implement a plan to collect fees to cover the estimated cost of regulating transactions under CFTC's jurisdiction. Implementing such a plan is subject to approval of

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1/National Cable Television Association, Inc. v. United States, 415 US 336 (1974); Federal Power Commission v. New England Power Company, 415 US 345 (1974); National Cable TV Association, Inc. v. FCC, 554 F. 2d 1094 (D.C. Cir. 1976); and Electronic Industries Association v. FCC, 554 F. 2d 1109.

2/We took this view in a March 28, 1980, report entitled "The Congress Should Consider Exploring Opportunities To Expand And Improve The Application Of User Charges By Federal Agencies" (PAD-80-25).

the House and Senate Agriculture Committees. Fees collected would be deposited in the Treasury as miscellaneous receipts.

Office of Management and Budget Circular No. A-25 sets forth general policies for agencies to follow in developing user charges. In particular, the circular states that when a service (or privilege) provides special benefits to an identifiable recipient above and beyond benefits that accrue to the public at large, a charge should be imposed to recover the full cost to the Federal Government of rendering that service. For example, a special benefit would be considered to accrue and a charge would be imposed when a Government-rendered service

--enables the beneficiary to obtain more immediate or substantial gains or values (which may or may not be measurable in monetary terms) than those which accrue to the general public (e.g., receiving a patent, crop insurance, or a license to carry on a specific business) or

--provides business stability or assures public confidence in the business activity of the beneficiary (e.g., certificates of necessity and convenience for airline routes or safety inspection of craft).

Within the context of this policy guidance, CFTC can assess a user charge for approving a contract. Approving a contract is analogous to licensing an exchange to carry on a specific business. In return for meeting the section 5 requirements of the act, CFTC approves the exchange's contract. As a result, exchange members can trade the commodity for their personal profit or trade the commodity for nonmembers in return for a commission. In addition, CFTC's review of contract terms and conditions, which is aimed at minimizing the potential for manipulation, can assure public confidence in the exchange's business.

Benefits from licensing exchanges do accrue to the general public. Trading in commodities lowers the business costs of a commodity's commercial users and producers through hedging. These lower costs are presumably passed on to the consumer.

In September 1981 we raised the question of assessing a user charge for contract approval with CFTC's Chairman. While the Chairman indicated that he had not given much consideration to user fees before our discussion, he considered it a worthwhile suggestion. He believed a user fee would have the benefit not only of defraying contract approval costs, but also of possibly discouraging frivolous exchange applications for contract approval.

Subsequent to our discussion with the Chairman, CFTC in October 1981 established a task force under the Executive Director to examine user fees. This task force reviewed both individual fees for specific CFTC activities, such as contract approvals, as well as an overall fee to be assessed on each futures transaction. Within the context of these alternatives, the task force recognized that court decisions interpreting the User Charge Statute are relevant to CFTC's fee authority.

We believe a user fee would help assure that adequate resources are available for the review of contracts so that these reviews can be comprehensive and timely. In establishing a user fee under section 26, we agree that CFTC needs to take into account applicable principles developed by court decisions interpreting the User Charge Statute. Consequently, CFTC may need to set its fees to take into account the benefits which accrue to exchanges and those which accrue to the general public.

CONCLUSIONS

CFTC now performs a more complete review of a proposed contract's compliance with its Guideline I requirements for contract approval than it did at the time of our 1978 review. CFTC has increased its emphasis on evaluating whether a proposed contract is likely to serve a price-basing or hedging function and has stressed in its review process the development of contract terms and conditions that mirror the cash market.

Despite this overall improvement, we believe aspects of CFTC's review could be refined. First, CFTC needs to establish an internal requirement that its analysis economists contact a significant portion of the potential hedgers who submit statements on the exchange's behalf. Second, CFTC needs to develop a standardized approach to determine what additional potential hedgers it will independently contact.

CFTC's proposed revisons to Guideline I would make the Guideline more specific regarding the requirements for demonstrating economic purpose and establishing sound contract terms and conditions. The proposed rules would also add meaning to the public interest test by linking satisfaction of the test to exchange compliance with the rule enforcement and market surveillance requirements of sections 5 and 5a of the act.

CFTC needs to increase the attention it gives to existing contracts. Since removing in 1978 the Regulation 1.50 requirement for regular 5-year reviews of contracts, CFTC has devoted increasingly less attention to this area. Because the act makes clear that the economic requirements for approval apply to existing contracts as well as proposed contracts, CFTC needs to establish an effective approach for reviewing existing contracts.

Although CFTC needs to fully and thoroughly evaluate a proposed contract for compliance with contract approval requirements, the agency can make administrative improvements that will allow it to perform this evaluation as quickly and efficiently as possible. First, instead of accepting individual hedging statements which arrive at CFTC sporadically, CFTC can require exchanges to provide, at the time of contract submission, either all the potential hedgers' statements the exchange wishes CFTC to consider or the actual interviews used to solicit the hedgers' views. Second, CFTC could also more consistently and effectively employ staff deadlines. Although the Economics and Education Division has begun to use informal staff deadlines, it has not devised a consistent system of employing deadlines in managing staff resources. Third, senior level officials could perform an initial review of a proposed contract and brief the assigned economist on particular aspects of the contract that need to be explored in depth. This procedure would cause the economists' review to be more focused, directed, and productive and help avoid last-minute delays in contract approval.

CFTC's contract approval process provides an excellent opportunity for implementing a user charge. We believe contract approval clearly fits within the Office of Management and Budget's policy guidance on when fees should be assessed. We see a user charge, which equitably assigns costs, as a method to provide a significant portion of the resources needed for comprehensive contract review.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To improve the approval process for new contracts, we recommend that the Commission take the following actions:

--Adopt the proposed Guideline I revisions.

--Establish procedures for analysis economists to follow in contacting cash market participants. These procedures should include using the expertise of CFTC surveillance economists.

--Require analysis economists to contact a significant portion of the potential hedgers who submit statements on behalf of an exchange applying for contract approval.

To provide for the comprehensive review of existing contracts, we recommend that the Commission:

--Establish an effective approach for reviewing existing contract markets. This approach should include (1) adopting the proposed rules on dormant and low-volume contracts, (2) identifying contracts that may not be serving an economic purpose and requiring exchanges to demonstrate that these contracts continued to comply with economic requirements, and (3) using surveillance economists to review terms and conditions of existing contracts for conformity to current cash market practices.

To expedite the contract review process, we recommend that the Commission:

- --Require exchanges to supply at the time of their application all the relevant support they intend to submit to demonstrate economic purpose.
- --Establish written staff deadlines for all phases of the review process.
- --Require senior level officials to perform an initial contract review and brief the assigned economist on contract aspects that should be explored.

We also recommend that the Commission charge a fee to collect contract approval process costs.

AGENCY COMMENTS AND OUR EVALUATION

In its comments on our draft report, CFTC stated that ascribing slow contract approvals to weak management of the Economics and Education Division is inappropriate. 1/ We acknowledge that our characterization of CFTC's contract approval process can be worded more appropriately. Therefore, to more aptly characterize our concerns about the process, we indicate that the process needs "improved administrative procedures" rather than "improved management."

CFTC attributes slow contract approvals to: (1) a tremendous growth in new applications, (2) the need to address CFTC's and other agencies' "fundamental and precedential" questions about innovative contracts, (3) the diversion of CFTC personnel from contract review to study of the 1980 silver crisis, and (4) senior management's emphasis on developing the regulatory prerequisites for contract approval.

During our review, we considered these factors but found that other factors, including CFTC's administrative procedures, also contributed to slowing the approval process. CFTC needs to improve its procedures through actions such as establishing written deadlines for staff and requiring exchanges to submit application materials in a timely manner. We acknowledge the importance of several of the reasons cited by CFTC for the backlog in approvals, including the growth in the number of contract applications, the controversial nature of some of the contract applications CFTC has had to consider and the complex policy issues raised by these contracts, sometimes slow exchange responses to

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1/CFTC's comments are presented in their entirety in app. XV.

CFTC inquiries about pending contracts, and the expanded review of proposed contracts CFTC has conducted in recent years. The reasons we cited for slow contract approval include all but one of the factors to which CFTC attributes the backlog in approvals. We did not include one of the factors to which CFTC refers--diversion of contract review staff to study the silver crisis--because this diversion of resources has comparatively little long-term impact on the contract approval process.

CFTC also stated that the processing of proposed futures contracts accelerated substantially in the last half of calendar year 1981, an accomplishment CFTC believes we did not acknowledge in our draft report.

Although our draft report demonstrated an increased rate of contract approvals, we agree that we could more explicitly recognize this acceleration. Therefore, we have pointed out that CFTC approved 20 contracts between July and December 1981.

Regarding reviews of existing contracts (1.50 reviews), CFTC stated that management decided to assign higher priority to new contracts and to review existing contracts only if significantly deficient. Further, CFTC stated that in fiscal year 1981 the Commission authorized 12 1.50 reviews--a review of a cotton contract and reviews of 11 contracts on one exchange (the New York Mercantile Exchange).

We recognize that CFTC's management has assigned a higher priority to new contracts than to existing contracts. In our report, we state that CFTC has performed few reviews of existing contracts because "CFTC has focused most of its attention on approving new contracts." We understand that CFTC limits 1.50 reviews to cases in which the Commission believes there are significant deficiencies which represent potential market problems. A more effective approach to ensure continuing compliance with the act's requirements would be for CFTC to review existing contracts before serious problems and deficiencies arise rather than waiting to act on contract deficiencies until after they have caused a problem. In addition to reviewing the adequacy of existing contract terms and conditions, CFTC needs to review existing contracts to determine if they continue to serve an economic purpose.

Regarding the number of 1.50 reviews issued in 1981, our analysis is presented in terms of calendar year 1981, while CFTC's comments are written in terms of fiscal year 1981. As our report states, CFTC issued no 1.50 reviews in calendar year 1981. The cotton contract review to which CFTC refers was issued in November 1980. The group of 11 1.50 reviews to which CFTC refers, although authorized, were never issued. Moreover, the authorization of these 1.50 reviews was a formality which arose in connection with an enforcement action that CFTC initiated against the New York Mercantile Exchange to address alleged trade practice abuses. The 1.50 reviews CFTC authorized against this exchange in no way constitute the sort of precautionary preventive economic review that we believe CFTC must perform in order to see that existing contracts continue to meet approval requirements, as stipulated in Regulation 1.50.

CFTC also made the following additional comments.

CFTC believes that rather than referring to CFTC's "approval of new contracts," we should refer to CFTC's "designation of contract markets." We selected "approval of new contracts" rather than the term "designation of contract markets" to minimize the use of technical terms. For clarity, we note that for the purpose of our discussion, "to receive approval to trade standardized contracts" is the same as "to be designated as a contract market." Moreover, in its 1981 annual report, CFTC referred to "approving a contract" rather than "designating a contract market."

CFTC asked us to change the terminology in our discussion of dormant contracts. We stated that CFTC proposed to "suspend trading in dormant contracts." CFTC prefers that we state that the proposal would require exchanges to "receive CFTC approval to restore trading in a dormant contract." The changes CFTC suggested have been incorporated.

Finally, CFTC wanted us to revise our discussion of contract approval requirements. First, in our discussion of the economic requirements for contract approval, CFTC suggested that we include the requirement that a contract not be conducive to price manipulation or distortion. Second, CFTC suggested that we clarify our statement regarding exceptions to the requirement that contract terms and conditions conform to cash market practices. CFTC suggested that we state that "if a term or condition does not conform to normal commercial practices, it must be shown why it is necessary or desirable." The changes CFTC suggested have been incorporated.

EXCHANGE COMMENTS AND OUR EVALUATION 1/

Chicago Board of Trade

The Chicago Board of Trade commented that our discussion of the contract approval process is based on the premise that proposed contracts should be rigorously held to Guideline I, a premise the Board of Trade believes to be erroneous. According to the exchange, the Congress intended that the proposed contracts be approved unless evidence exists that a contract will be contrary to the public interest. Therefore, the exchange believes

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1/The exchanges' comments are presented in their entirety in app. XVI.

that Guideline I, which sets forth economic requirements for contract approval, misinterprets congressional intent.

We do not agree that Guideline I misinterprets the public interest requirement. The Conference Report accompanying the 1974 legislation which created CFTC states that although only the Senate's broad "public interest test" language appears in the act, this test includes the House of Representatives' concept of an "economic purpose" test. Guideline I's requirement that exchanges establish the commercial viability of the contract by justifying its terms and conditions, is appropriate since well-constructed contract terms and conditions reduce the potential for market manipulation and increase the economic benefits of trading the contract.

As for the issue of delayed exchange responses to CFTC, which we present as one reason for slow contract approval, the Chicago Board of Trade maintained that it makes every effort to provide timely responses to CFTC inquiries about proposed contracts. However, as the Board of Trade explained, the information CFTC requests often cannot be gathered "overnight." Moreover, when CFTC requires the exchange to amend the proposed contract's rules, the exchange must undertake the time-consuming process of seeking its Board of Directors' approval.

We understand that exchange replies to CFTC inquiries are sometimes delayed because of the time-consuming nature of CFTC's requests. However, we have fully recognized this situation in our report. We included a Board of Trade economist's statement explaining that the exchange has to spend considerable time and resources to answer CFTC's queries, to demonstrate the exchange's plight.

Chicago Mercantile Exchange

The Chicago Mercantile Exchange did not agree that CFTC should develop a more meaningful public interest test. The exchange believes its interpretation of the act's public interest requirement--that it requires only that the exchange demonstrate the soundness of a proposed contract's terms and conditions--is consistent with congressional intent.

We do not accept the exchange's argument. The Chicago Mercantile Exchange's interpretation of the public interest test differs from the interpretations CFTC and other exchanges have set forth. For the contract approval process to function with integrity and efficiency, it is important that all actors in the contract approval process have the same understanding of the public interest requirement. Since the Congress has charged CFTC with regulating futures trading, it is the agency's responsibility to formulate a clear and definitive public interest standard against which futures contracts are to be judged.

MidAmerica Commodity Exchange

The MidAmerica Commodity Exchange believes that exchanges, for the most part, are not responsible for slowing the contract approval process. MidAmerica believes that only a slight relationship exists between a proposed contract's quality and the length of time required for its approval. MidAmerica also disagreed with CFTC's assertion that contract approval often slows because exchanges either have difficulty, or are uninterested, in responding to CFTC's requests. When exchange responses have been delayed, MidAmerica believes the exchanges should not be blamed because: (1) the delay may have resulted from the press of exchange business, (2) the response may have required a great deal of time to prepare, and (3) the requested information is known or should be known by CFTC.

Our discussion of delayed exchange responses to CFTC inquiries provides a balanced representation of differing views. While we include CFTC's charge that exchanges are slow in responding, we also include exchange explanations regarding why these delays occurred.

Furthermore, we said that untimely exchange replies to CFTC was only one of several factors contributing to backlogged contract approvals. We found that CFTC contract approvals were also slowed by expanded contract reviews, complex policy issues, a rapid increase in contract applications, and the need for improved CFTC administrative procedures. In addition, we found that for some contracts lengthy time periods did elapse between the date that CFTC requested information on the contract and the date the exchange replied. While CFTC and the exchanges do not agree about why exchange responses were delayed, these delays nonetheless stand as one factor of several contributing to slow contract approvals.

MidAmerica also suggested a slight change to our characterization of a MidAmerica vice president's statement. We reported that he stated that MidAmerica does not submit contracts to CFTC until they are ready to trade. MidAmerica believes it is more correct to say that the exchange does not submit contracts until the applications conform to Guideline I. MidAmerica's suggested changes have been incorporated.

CHAPTER 4

MARKET SURVEILLANCE IMPROVEMENTS DEPEND ON BETTER DATA COLLECTION AND ANALYSIS

CFTC and the commodity exchanges conduct market surveillance programs to identify adverse market situations and prevent them from disrupting futures markets. Through their market surveillance programs, CFTC and the exchanges collect, analyze, and compare, on a daily basis, data on supply and demand conditions in both the cash and futures markets and, in particular, on the size and dominance of traders' positions in futures markets. Because of weaknesses in its overall automatic data processing (ADP) system, CFTC is unable to collect and analyze this data in a manner that can most effectively support its surveillance program. Improvements in its ADP system and subsequent revision of its data collection systems could increase the output of CFTC's market surveillance staff.

Commodity exchanges, as self-regulatory organizations, are primarily responsible for protecting the integrity of their markets. They cannot fulfill this responsibility if they do not have adequate surveillance data for their markets. Since many exchanges do not maintain extensive large-trader data systems, CFTC often knows more about the positions of individual traders in a particular exchange's market than the exchange does. CFTC can either require the exchanges to collect this data or supply it to the exchanges for a fee.

HOW MARKET SURVEILLANCE WORKS

To serve their economic purpose of hedging and price basing, futures markets for individual commodities must function competitively, free from artificial prices or distortions. The goals of market surveillance are to spot adverse situations in futures markets--primarily price manipulations--as they develop and to prevent disruption of these markets. To accomplish these goals, a market surveillance program must determine when a trader's position in a futures market becomes so dominant that it is capable of causing that market to no longer accurately reflect supply and demand conditions. Consequently, a surveillance program needs to collect, analyze, and compare, on a daily basis, data concerning overall supply and demand conditions in the cash market, supplies that are deliverable against the futures contract, cash and futures prices and price relationships, and the size and dominance of traders' positions in the futures market.

Both CFTC and the exchanges conduct market surveillance programs. When a market problem is detected, various actions are possible. CFTC and/or the exchange will contact the trader (or traders) whose position in the futures market is considered to be a potential source of disruption. They will ask the trader about his or her intentions and remind him or her of his or her responsibility to avoid market disruptions. They will continue to monitor the trader's position as the contract's expiration date approaches, gradually increasing pressure if the troublesome position is not eliminated or reduced. Ultimately, CFTC (under section 8a(9) of the act) or the exchanges may declare a market emergency and take specific actions designed to restore an orderly market.

CFTC's Economics and Education Division conducts CFTC's market surveillance program. Although the Division has a market surveillance section, actual surveillance is conducted in CFTC's New York and Chicago regional offices. Within the regions, the market surveillance staff is divided into two groups--surveillance and reports processing. Economists in the surveillance group perform the actual analytical work, while clerks in the reports processing group process the large amounts of trader position information CFTC receives. Statistical assistants or economic assistants support the economists by collecting and recording data and performing computations.

Since our 1978 review, the number of CFTC's surveillance economists has remained relatively stable. Because of the continued growth of the futures industry, however, the average number of commodities assigned to each economist has increased. The associate director, market surveillance, stated that expected continued growth, coupled with static surveillance staffing levels, will further increase the workload of individual surveillance economists. 1/

CFTC CAN FURTHER IMPROVE ITS COLLECTION OF LARGE-TRADER DATA

The essential objective of market surveillance is to prevent individuals or groups of traders from controlling or manipulating the futures market. Consequently, a large-trader reporting system that provides reliable, timely data is an integral part of an effective surveillance program. CFTC operates an extensive large-trader reporting system which consumes a significant portion of the agency's budget each year. This system cost $1,043,000, or about 5 percent of CFTC's fiscal year 1981 budget, and used about 10 percent of its staff years for fiscal year 1981. CFTC's current large-trader system has had problems with (1) collecting duplicate data from different sources and (2) providing surveillance economists with the most timely and useful data. CFTC

1/Growth has occurred not only in the number of futures contracts traded but also in the sheer volume of trading (see app. I for recent statistics). Additional growth will occur in futures contracts and in the recently approved commodity options pilot program.

has reduced the duplication by eliminating one routine report, but it has not addressed other inadequacies of its large-trader reporting system due to weaknesses in CFTC's ADP system.

CFTC's large-trader system requires daily reports from two primary sources: exchanges and Futures Commission Merchants or foreign brokers that handle futures trading accounts. Exchanges must report to CFTC by commodity, by future, and by clearingmember, 1/ position, trading, and delivery information. Surveillance economists call this data the '00 reports or clearinghouse sheets. FCMs and foreign brokers must report (the series '01 report) positions in all accounts carried on their books separately for each exchange and each future that equal or exceed a reporting level fixed by CFTC. 2/ FCMs and foreign brokers also report information on who owns and controls accounts to CFTC (Form 102).

Before January 1, 1982, individual traders who owned or controlled a reportable position in a commodity were required to report routinely (the series '03 reports) their total positions in each contract market as well as their trading activity and deliveries made and received. Now traders must file this information only when CFTC specifically requests it. Traders still must provide additional biographical and account ownership and control information (Form 40). Individual traders using futures markets for hedging purposes must also file a weekly report (series '04 report) showing their actual holdings of the physical commodities in which CFTC has established speculative position limits. 3/

1/A clearingmember belongs to a clearinghouse--an adjunct to a commodity exchange through which transactions executed on the floor of the exchange are settled.

2/In 1978 we recommended that CFTC determine the costs and benefits of replacing the system of obtaining reports from traders and FCMs with daily reporting of detailed trade information from exchange clearinghouses. Our recommendation was not adopted because surveillance officials believed that getting trader data from the FCMs is the most efficient approach. They noted that exchanges that collect large-trader data do so independently of their clearing process.

3/Speculative position limits set a maximum on the futures positions a speculator can hold. CFTC speculative position limits currently exist for wheat, corn, oats, rye, barley, flaxseed, soybeans, eggs, potatoes, and cotton. Speculative limits do not apply to futures positions that are hedged in the cash market.

CFTC has reduced duplication in its reporting system

In order to reduce duplication in its reporting system, CFTC recently eliminated the filing requirement for the series '03 report. This elimination involved considerable alterations to the computer programs that run CFTC's large-trader reporting system. The elimination project was poorly planned and, as a result, experienced delay.

The '01 and '03 reports collect essentially the same information. Before the 1970's, series '03 reports were adequate for surveillance purposes because of the physical proximity of the largest of the traders in New York and Chicago. This ensured that the bulk of the reported information was timely and futures trading was low enough that futures trading data could be handled promptly by CFTC's predecessor agency. However, as trading volume increased, the locations of traders decentralized.

As the trends in growth and decentralization continued, the '01 reports FCMs filed gradually replaced the '03 reports as the major reports used for surveillance. The '01 reports were received more quickly than the '03 reports (hand delivered daily by the FCMs vs. mailed in by individual traders). Moreover, the series '03 reports came to be filed by less experienced, less professional traders; therefore, they became increasingly less accurate.

In January 1982 CFTC eliminated the requirement for filing '03 reports and increased its reliance on the '01 reports and Forms 102 and 40 for routine large-trader data. CFTC officials told us that they eliminated the '03 report filing requirement for several reasons: the report duplicated the '01 report; its reduced timeliness and accuracy made the report less useful for surveillance purposes; costly staff and computer resources were needed to process the increasing amounts of '03 reports received; and eliminating the report would implement the Paperwork Reduction Act (44 U.S.C. 3501 _et seq_.).

The idea of eliminating the '03 report was not new. In June 1976 CFTC's Chief Economist reported on the '03 report's inaccuracy, untimeliness, and duplication and proposed eliminating it. 1/ Subsequently, in July 1976, CFTC requested public comment on discontinuing the report. However, a CFTC ADP official

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1/In our 1978 report, we noted this proposal as well as others the Chief Economist made to improve market surveillance. We recommended that CFTC develop a plan to implement these changes. Former and current CFTC surveillance officials told us that although CFTC did not produce such a plan, it did act on the Chief Economist's proposals.

told us no action was taken regarding the '03 elimination until early in 1981. The previous Director, ADP, told us that because of ADP problems, CFTC was unable to attempt this project before January 1981. 1/

The actual '03 elimination project was poorly planned and, as a result, experienced delay. For example, in June 1981, in anticipation of eliminating the '03 report, CFTC began requiring FCMs and foreign brokers to report daily on the '01 report exchange of futures for cash and delivery information. However, the necessary computer programs to generate reports from this data were not written when the requirement became effective; thus the data was essentially useless to the surveillance economists. Additional project management problems contributed to several postponements of the elimination of the '03 reporting requirement until January 1982. Even so, not all of the necessary computer programing was completed by January 1982. As a result, CFTC has had to suspend publication of a report on "Commmitments of Traders" and manually screen hedgers from a report showing violators of CFTC speculative limits. 2/ In any event, only the filing requirement for '03 reports has been eliminated. The computer programs that processed the '03 data remain and will process the remaining '01 data to produce certain outputs used by surveillance economists. Thus, there will be very little computer processing savings by eliminating the '03 report.

1/These problems, including inadequate ADP staff and lack of software documentation, are discussed in ch. 9.

2/Currently, CFTC produces a computer report that identifies traders whose positions are over CFTC speculative position limits. Hedgers, who are exempt from these limits, were identified on the '03 reports. Without the '03 reports, CFTC plans to use the Form 40 to identify hedgers. Traders will be required to identify themselves as commercially or noncommercially involved with the commodities they are trading. CFTC will assume that traders with a commercial interest in a particular commodity are hedgers in that commodity. The computer programing to make this change is not complete. Therefore, the speculative limit violation report will show all traders, both commercial (hedgers) and noncommercial (speculators), with positions over the speculative limit. CFTC will have to manually refer to the Form 40s to eliminate exempt hedgers.

CFTC can address other reporting system weaknesses

The large-trader data received from FCMs on the '01 reports is processed by CFTC's computer. The computer produces a series of output reports showing traders' positions, and these reports are used by the surveillance economists to perform their surveillance. By addressing problems with the timeliness of output reports, inadequate data verification, and inappropriate reporting levels, CFTC can improve its large-trader reporting system and increase its usefulness to surveillance economists.

The director, market surveillance branch, Chicago, told us that the '01 output reports for the previous day's trading are not usually received in Chicago until 2:30 p.m. The New York reports processing group chief told us that until some recent data processing changes were made, the '01 outputs were not received in New York until 4:00 p.m. (they are now received at 2:30 p.m.). Computer breakdowns can cause surveillance economists to receive large-trader data even later, sometimes even the following day, by which time the information is almost 2 days old. Surveillance economists told us that even when the 2:30 target is met, the data is not as timely as it could be. Receiving data by 2:30 means that almost a full day's trading has occurred before CFTC is able to find out what traders' positions were on the preceding day.

In contrast to CFTC, the Chicago Mercantile Exchange, which operates a large-trader system similar to CFTC's, has its reports for the preceding day done by 9:30 a.m. Most of the inputs the exchange receives are in machine-readable form, whereas CFTC only receives machine-readable inputs from two FCMs. As a result, CFTC has to manually enter large-trader data into its computer--a time-consuming task.

The primary reason for the lengthy time needed to produce the '01 outputs is that the hard-copy inputs are not required from the FCMs until 30 minutes before the exchanges open--usually about 9:30 to 10:00 a.m. They must be reviewed, key punched, run, edited, and then printed and distributed. Any difficulties in this process create delay. The potential for delay is increased in New York, where data must be key punched, transmitted to Chicago, run on the computer there, transmitted back to New York, and then printed and distributed.

Because the outputs are often received late, to be current on the futures markets, CFTC surveillance economists must often take time away from their analytical duties to manually update large-trader data. This is particularly the case on Thursdays, when surveillance economists prepare their weekly report. This report is telexed to Washington at the close of business for use at the Commission's Friday surveillance briefing. The computer outputs are not received in time to prepare the weekly report;

thus, the traders' positions must be updated manually. Reflecting New York's chronic ADP problems, this happens more often in New York than Chicago. As a result of this problem, in a critical liquidation CFTC economists can be unaware of the positions of dominant traders until they manually sort through the inputs received from the FCMs and exchanges.

Timeliness problems are not confined to the daily '01 outputs. CFTC has computer programs that can present large-trader data in various formats. However, our discussions with surveillance economists indicate that they do not often request special reports because the reports usually take several days to receive, thus reducing their usefulness.

More can be done to verify CFTC's large-trader data. Until the '03 reports were eliminated, the computer did produce an '01/'03 check report that made limited comparisons of data from the two reports and could detect gross errors. To take the place of this report, CFTC plans to check the '01 reports against the '00 reports; however, because the necessary computer programing does not exist, this check can only be done manually.

Data from the '01 and the '04 reports is not routinely verified. The associate director, market surveillance, and the reports processing group chiefs in New York and Chicago agreed that the lack of verification is a potential weakness. They believe the '01 reports are reasonably accurate because the FCMs who prepare them need to know traders' positions to establish and maintain required margin accounts; thus, they have an important incentive to ensure accuracy. Moreover, the associate director, market surveillance, told us that CFTC plans to use a staff position made available by the '03 elimination to hire an auditor for each region who will be used to verify the FCM's accuracy in completing the '01 report.

CFTC's reporting system covers all futures in all active contracts with the same reporting level. The greatest emphasis in surveillance, however, is usually placed on the maturing futures because markets are most susceptible to manipulation or price distortion during the expiration period. This has led to the proposal, first made by CFTC in July 1976, that a two-tiered reporting level be adopted. This would involve (1) lower reporting levels during expiration, when the '01 system currently does not collect as much data as would be most useful, and (2) higher reporting levels for distant futures, when the '01 system currently collects more data than CFTC needs or can effectively use. In a May 1981 memorandum the chief, New York market surveillance group, and the director, New York market surveillance branch, supported this approach. The two-tiered approach was also supported by the associate director, market surveillance, and by many of the surveillance economists we interviewed.

In view of these potential areas where improvement could be made, we asked the associate director, market surveillance, why a complete overhaul of the large-trader reporting system has not been attempted. He acknowledged that a new system would be desirable but believed that it would have to wait until a new ADP system was developed. The former Director, ADP, told us that rather than eliminate the '03 report, he would have preferred to develop a new large-trader reporting system that did not include the '03 reports and that provided improvements over CFTC's current system. He believed that the computer software that supports the current large-trader reporting system is unreliable and too poorly documented to be fully understood or improved. He also believed these programs are so inadequate that it would prove extremely difficult, as it has, to make the modifications necessary to eliminate the '03 report. He told us that the reason the '03 was eliminated was because the computer and staff burden of the '03 report was becoming too great. Also, he stated that CFTC had hired computer programers to initially work on computer software for the registration program. When this effort was delayed, these programers were assigned to the '03 elimination project.

CFTC MAKES LITTLE USE OF ADP TO ANALYZE SURVEILLANCE DATA, RESULTING IN A WEAKER SURVEILLANCE EFFORT

Effective surveillance requires not only the collection but also the analysis and comparison of data in a systematic and timely fashion. Comparisons must be made between large-trader position data and a future's open interest--the amount of unliquidated contracts--to determine whether a particular trader has achieved a level of dominance which could influence the market. Other data must be analyzed to determine if the potential distortions are actually occurring. For example, in orderly liquidations the prices in futures and cash markets tend to converge as traders take advantage of price differences between the two markets. Failure of these prices to converge may indicate price manipulation or an underlying market problem; therefore, the difference between these prices must be computed and analyzed daily.

CFTC uses ADP to collect and compile large-trader data. CFTC also receives futures price, volume, and open-interest data in hard-copy format from the exchanges daily. 1/ This data is entered in CFTC's computer and becomes part of a permanent record. Other data, such as cash prices, are not entered.

1/In addition to supplying this data in a hard-copy format, the Chicago Board of Trade also supplies a monthly summary of this data on computer tape.

For the most part, CFTC does not use ADP to analyze this data. Outputs for the large-trader reporting system are limited to fixed reports showing traders' positions. No comparison using ADP is made between a trader's position and open interest, even though both data elements are entered in CFTC's computer. Similarly, other systematic, computerized analyses are not made of futures price, volume, and open-interest data.

This situation is the result of the weaknesses in CFTC's overall ADP system, which are discussed in chapter 9. The system as it relates to surveillance was designed to be, as one surveillance official stated, a "big adding machine" that would process large-trader information in batches and produce a fixed number of reports. CFTC's Executive Director and Deputy Executive Director told us that CFTC has not developed ADP systems that would allow expanded analysis of large-trader or other market data.

The lack of ADP support has affected the surveillance program in numerous ways. For example, CFTC must maintain duplicate data systems. In New York and Chicago, surveillance economists and their assistants manually record futures prices, volume, and open-interest data in ledgers or notebooks even though the same data is entered in the computer. The duplicate data is kept because the economists need to analyze changes in and differences between the data--computations CFTC's current computerized systems cannot perform. The necessary computations are, as a result, done manually.

Many staff members are needed to perform CFTC's routine data collection and analysis. In Chicago five statistical assistants and one economic assistant record data and perform the necessary computations. In New York two economic assistants perform these functions. The director of the market surveillance branch in Chicago and the chief of the market surveillance group in New York told us that the situation is more serious in New York where the small number of economic assistants necessitates economists taking time from their analyses to perform many of the routine computations.

Surveillance economists told us that comparisons of additional data series--such as cash prices--which would enhance their surveillance effort are not done because the manual processing means it takes too long to collect and analyze the data. Surveillance economists also told us that the manual processing makes it cumbersome to compare data for the current expiring future with data for past liquidations whereas a computer could make such comparisons more efficiently.

Insufficient ADP support has also inhibited the development of more sophisticated surveillance techniques. In 1978 we recommended that CFTC develop "quantitative indicators" as an aid in detecting developing market problems. 1/ The associate director, market surveillance, told us that no action has been taken on this recommendation primarily because of CFTC's limited ADP capabilities. Nonetheless, opportunities continue to exist to use quantitative indicators. For example, the statistical techniques of correlation analysis and frequency distribution could be used to detect or verify a group of individuals trading under a common plan when they have not revealed their relationship to CFTC. 2/ Currently, economists try to detect these relationships by visually scanning the large-trader reports--an approach that we believe is not satisfactory. The associate director, market surveillance, acknowledged the benefit of the analytical approach and said that his section has wanted to use this technique for several years, but CFTC's ADP systems are not programed to make such correlations among the large-trader data.

The Economics and Education Division has had some experience using small (mini and micro) computers in its market surveillance program. CFTC surveillance officials told us that because the technical characteristics of these computers were not adequately suited to the needs of the surveillance program, these computers could not significantly contribute to the productivity of the program. In particular, the computers have not been (1) usable by individuals who do not have strong computer backgrounds and (2) able to deliver timely analysis. Nevertheless, our discussions with surveillance economists indicated that the computers did allow them to more efficiently explore relationships among data series and perform more sophisticated surveillance.

CFTC has recently taken actions that could ultimately improve its use of ADP in market surveillance. As part of its intended commodity options pilot program, CFTC is requiring exchanges to report in machine-readable form (that is, computer tapes or discs that can be inputed directly into CFTC's computer) and in hard-copy data on large-trader option positions and data on option price, volume, and open interest. It is also extending the machine-readable requirement to data on clearingmembers (the '00 reports) and on all futures prices, volume, and open interest.

Before the Commission's decision to go ahead with the options pilot program, the Director, Economics and Education Division,

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1/A quantitative indicator would show, for example, when a trader's share of open interest when compared with previous liquidations had reached a potentially dangerous level.

2/Traders are required to report on CFTC Form 40 futures trading relationships they may have with other traders. If a group of traders intends to manipulate the market or evade speculative position limits, they will not want to report their relationship to CFTC.

recommended in a September 1981 memorandum to the Executive Director that CFTC hire an outside contractor to perform the required ADP services for options. He also recommended that CFTC use the outside contractor to more fully automate futures market data. In particular, he suggested that CFTC (1) add cash prices to a computerized data base that would include existing computerized price, volume, and open-interest data, (2) develop the capability to make comparisons among cash and futures price data and display this data in graphic and tabular form, and (3) use computerized '00 reports to check '01 reports. CFTC's Washington-based ADP group has begun work on the computer programing needed to process the options data and add cash prices to CFTC's data base. CFTC market surveillance officials have also met with outside contractors to discuss developing ADP systems to provide tables containing futures data, which economists can use in conducting their surveillance.

In chapter 9 we also discuss other overall improvements in CFTC's ADP system that can help improve the application of ADP to market surveillance.

COMMODITY EXCHANGES NEED TO BE PRIMARILY RESPONSIBLE FOR MARKET SURVEILLANCE

Both CFTC and the exchanges need market surveillance programs. Under section 5(d) of the act, CFTC may designate only those contract markets that demonstrate their ability to prevent price manipulations and corners (see glossary). In this regard, section 5a(8), as implemented by Regulation 1.51(a)(1), requires that exchanges, as self-regulatory entities, maintain an affirmative action program that includes "surveillance of market activity for indication of possible congestion or other market situations conducive to possible price distortion."

Although CFTC has broad responsibility under the act for ensuring the integrity of futures markets, exchanges have primary responsibility for market surveillance and should, in our view, bear the major part of the burden for protecting the integrity of their markets.

In 1978 we noted this partially unavoidable overlap in surveillance activities and recommended that CFTC conduct a study with the assistance of the exchanges to identify and eliminate unnecessary duplication, increase understanding and coordination, and establish clear lines of responsibility. CFTC did not study all of these areas. Rather, market surveillance officials said that they focused their attention on what they considered the major potential area for duplication--large-trader reporting.

Data on large-trader positions varies among exchanges

Surveillance programs vary considerably both among the exchanges and when compared with CFTC. This variation extends to how programs are organized, what authority the exchange market surveillance staff has, and, in particular, what data is gathered for surveillance purposes. The differences are most apparent in the collection of large-trader data. Some exchanges routinely collect data on individual traders' positions for use in market surveillance. Other exchanges use their clearingmembers' total long and short positions (see glossary), which include the positions of many traders, in their market surveillance programs. They may, however, collect data on specific large traders when they believe market conditions warrant it or to enforce exchange speculative limits. As noted previously, CFTC maintains an extensive large-trader reporting system.

Since the essential objective of market surveillance is to prevent individuals or groups of traders from controlling or manipulating a futures market, a large-trader reporting system is an integral part of an effective surveillance program. CFTC's Guideline II, which is intended to amplify and clarify exchange responsibilities under Regulation 1.51 in the area of large-trader data, states that an adequate market surveillance program should include surveillance of "concentrations of positions among clearing members." With only such broad guidance as this to rely on, an individual exchange's philosophy on market surveillance is often reflected in the amount of large-trader data it collects. 1/ For example, the head of market surveillance at the Chicago Mercantile Exchange told us that the exchange views market surveillance and the protection of market integrity as an important way of fostering public confidence in the exchange's markets. Consequently, the exchange has an extensive large-trader reporting system that collects data in greater detail than even CFTC. 2/ In contrast, the head of market surveillance at the Chicago Board of Trade told us that the exchange takes a more laissez-faire approach toward its markets and therefore places less emphasis on collecting detailed large-trader data. 3/

1/In ch. 7, we recommend that CFTC revise Guideline II to make the requirements more specific for exchange market surveillance programs.

2/The Chicago Mercantile Exchange's comments on this chapter are in app. XVI.

3/The Chicago Board of Trade's comments on this chapter are in app. XVI.

Because many exchanges do not maintain extensive large-trader reporting systems, CFTC often knows more about the positions of individual traders trading on that exchange than does the exchange itself. As a result, several exchanges regularly rely on CFTC for large-trader data. For example, the market surveillance directors at the Commodity Exchange, Inc., and the Chicago Board of Trade told us that when they need detailed large-trader data, they contact CFTC. The Chicago Board of Trade went so far as to propose in March 1977, June 1977, and September 1978 that it no longer be required to collect any position information and instead have CFTC supply it with large-trader data. However, in February 1982 this proposal was withdrawn. 1/

Because they do not have extensive large-trader reporting systems, exchanges must depend on CFTC to identify and call to their attention potentially troublesome positions before they are in a position to fulfill their responsibilities. For example, a historically small 1980 oats crop posed potential delivery problems in 1981 oats futures traded on the Chicago Board of Trade. To avoid price distortion, it became necessary to identify traders and the extent of their positions and assess their intentions and capabilities to make or take futures delivery. Identifying traders was complicated because large traders were going through multiple clearingmembers of the Chicago Board of Trade. The associate director, market surveillance, told us that the exchange's data system could not adequately identify these traders and thus CFTC had to contact the exchange and identify the various large-trader accounts so action could be taken.

The need for improved exchange large-trader data systems is further increased by CFTC's recent decision on speculative position limits. In response to the events in the silver market in 1979-1980, when several speculators were able to amass very large positions and thus contribute to the pronounced increase in silver prices, CFTC, in September 1981, approved new rules that require exchanges to set speculative position limits. CFTC and exchange market surveillance officials told us that without adequate large-trader reporting systems, the exchanges will not be able to enforce the speculative limits they develop. We believe, therefore, that large positions could be amassed again.

CFTC has recognized this anomaly. In an August 1980 proposed rule change, CFTC concluded that in most markets clearing-member data alone is not sufficient for market surveillance

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1/On April 12, 1982, CFTC issued its rule-enforcement review of the Chicago Board of Trade. CFTC found that the Board of Trade's ability to monitor large traders, other than by obtaining the information from CFTC, was inadequate. In response, the Board of Trade agreed to implement within 1 year a large-trader reporting system.

purposes. CFTC stated that an effective market surveillance program requires the ability to monitor futures positions of individual traders and is critical for exchanges to fulfill their responsibility under section 5(d). CFTC proposed that exchanges collect and process large-trader data. This information would be forwarded to CFTC daily in machine-readable form and ultimately could replace CFTC's own large-trader reporting system.

Six commodity exchanges commented on CFTC's proposal; five exchanges opposed collecting large-trader data. In objecting to CFTC's proposed rule change, two or more of the exchanges raised three major concerns:

--They believed that their lack of jurisdiction over nonmember FCMs and foreign brokers would limit their effectiveness in collecting large-trader data.

--They expressed concerns about their ability to maintain the confidentiality of the data.

--They felt that establishing a reporting system at each exchange would be costly and would duplicate CFTC's existing system.

The associate director, market surveillance, believed that if each exchange individually collected large-trader data, overall costs to the industry would be higher. He also believed that if CFTC wished to terminate its own reporting system, thus reducing duplication, it would have to establish and enforce clear standards for large-trader data--an effort that could require as many resources as the operation of its current reporting system.

As of December 1981, the associate director, market surveillance, told us that CFTC had not taken any action on its large-trader proposal. In regulations for its new options pilot program, however, CFTC has required exchanges to collect and supply it with weekly large-trader position data for expiring options. CFTC's Chairman told us that he wanted to use the options program to test whether the exchanges have the capability to collect and supply large-trader data before applying such a requirement to futures positions.

Alternatives exist for improving exchange large-trader data

Other ways exist that could ensure that the exchanges have the data necessary to conduct adequate surveillance and still ensure that the exchanges also bear a fair share of the cost of collecting surveillance data:

--CFTC could continue to collect large-trader data but routinely supply it to the exchanges for a fee.

--Large-trader data could be collected by an industrywide self-regulatory organization such as NFA and disseminated to CFTC and the exchanges.

Both of these alternatives try to address the question of cost and unnecessary duplication. Most of the CFTC surveillance officials we spoke with, as well as a former CFTC Chief Economist, agreed that economies of scale could be achieved by centralizing the collection and processing of large-trader data. The quality and reliability of the data could also be improved by applying reporting and aggregation requirements consistently.

The first alternative also has other advantages. CFTC already has in place an extensive large-trader data collection system, while, as the associate director, market surveillance, noted, most exchanges would have to develop one. CFTC also has the ability to require large-trader information from FCMs and traders who are not exchange members, while the exchanges' authority to enforce their rules extends only to their members.

Despite the first alternative's advantages, several factors could affect CFTC's ability to implement it. These factors are described below.

First, large-trader information is considered confidential under the act. Section 8(a) prohibits CFTC from publishing information that would separately disclose transactions or positions of any person. Section 8a(6) does allow CFTC to share large-trader information with exchanges when it believes the trader positions may disrupt or tend to disrupt the market. CFTC's Office of General Counsel does not regard this as authority for routine transfers (disclosure) of confidential large-trader data. This section of the act needs to be amended if this alternative is to be adopted.

Second, CFTC needs to take into account its authority under section 26 of the Futures Trading Act of 1978 and the Independent Offices Appropriation Act, 1952, and subsequent court decisions in designing a user charge for large-trader data provided to commodity exchanges. We believe the issues surrounding user charges discussed in chapter 3 apply here also.

Third, relying on CFTC to provide large-trader data to exchanges would increase the demands on CFTC's already strained report processing and ADP resources. CFTC would assume increased responsibility for accurate, timely data--areas in which it has previously experienced problems. Finally, the act creates a structure for self-regulation by the exchanges. Having exchanges depend on CFTC for large-trader information might be viewed as being inconsistent with self-regulation.

The second alternative--to have NFA collect large-trader data--would avoid the problem of straining CFTC's computer resources and would also be more consistent with the concept of self-regulation. Exchange and CFTC officials, however, voiced concerns about the ability of NFA to protect the confidentiality of large-trader data. The associate director, market surveillance, also questioned whether NFA could handle such a system so early in its development while trying to address its numerous other responsibilities. (The anticipated self-regulatory activities of NFA are discussed in chs. 5, 6, and 8.)

CONCLUSIONS

Faced with a growing futures industry and a static surveillance staffing level, CFTC needs to identify and explore approaches that will increase the productivity and effectiveness of its surveillance staff. One way to do this is for CFTC to improve its large-trader reporting system so that it provides the reliable, timely data that is vital to preventing individuals or groups of traders from controlling or manipulating the futures market. To accomplish this we believe CFTC needs to design a new large-trader reporting system. This effort would begin with a clear definition of market surveillance information needs. It would then identify the data outputs and reporting formats which would be most useful to surveillance economists. In addition, CFTC needs to investigate ways to increase the amount of machine-readable large-trader data it receives from FCMs in order to improve both the timeliness and accuracy of outputs. Finally, CFTC could utilize the resources freed up by the '03 report elimination to maintain the necessary level of data accuracy. The net result would be a system that meets the goal of producing timely, efficient, and accurate large-trader information.

CFTC's limited experience with using ADP to support market surveillance suggests the potential for significant payoffs from additional ADP applications, provided the approach developed (1) is usable by individuals who do not have strong computer backgrounds and (2) can deliver needed analysis in a timely manner.

By requiring exchanges to provide clearingmember, price, volume, and open-interest data in machine-readable form, and by starting to enter cash prices into its computer, CFTC has established the framework for a computerized surveillance data base. It must next develop the necessary computer programs to analyze this data and produce timely outputs. CFTC needs to also improve and expand the use of ADP as it is applied to more sophisticated analysis techniques. We continue to believe, as we stated in 1978, that opportunities exist for CFTC to develop quantitative indicators. Significantly, the use of correlation analysis to study trading patterns is one generally recognized technique to improve the surveillance process which could be implemented with CFTC's current large-trader data base.

The exchanges, as self-regulatory entities, have primary responsibility for market surveillance. In this role they, no less than CFTC, need complete, accurate, and timely data on the futures and cash markets and the positions of large traders. In this latter area, however, the exchanges are in what we believe is an inappropriately reactive posture; that is, they must rely on CFTC to identify and supply data on potentially troublesome positions before they can fulfill their self-regulatory responsibilities.

We believe CFTC needs to broaden its August 1980 proposal on large-trader data collection systems to include the concept of CFTC routinely supplying large-trader data to exchanges for a fee. This approach would help CFTC determine how a user charge could be structured. The Congress can help CFTC develop this approach by amending section 8a(6) to allow for the routine sharing of data with appropriate exchange officials. Also, the NFA will likely begin operation, thus providing a practical demonstration of its ability to handle a responsibility such as collecting large-trader data. With the experience of how well exchanges collect position data during the options program, as well as that of NFA, in hand, and with a clearer view of the fee and confidentiality questions, CFTC would be able to address the question of how to assure that the exchanges have available, adequate large-trader data.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To improve CFTC's market surveillance program we recommend that the Commission:

--Establish and implement a project to improve its large-trader reporting system. Such a project should include: defining surveillance economists' needs regarding large-trader data and reporting outputs, exploring the use of machine-readable inputs, and identifying resources needed to maintain the necessary accuracy level.

--Establish a program to (1) improve the application of ADP in routine analysis of surveillance data and (2) to develop more sophisticated analytical techniques for surveillance.

To move commodity exchanges to the forefront of market surveillance, we recommend that the Commission:

--Comprehensively address how to assure that exchanges have available adequate large-trader data. This can be accomplished by using CFTC's planned options program to test the ability of exchanges to successfully collect and process large-trader data and by broadening the August 1980 proposed rules on large-trader data collection to assess the issues surrounding CFTC's routinely supplying large-trader data to exchanges in return for a fee.

RECOMMENDATION TO THE CONGRESS

We recommend that the Congress amend section 8a(6) to authorize CFTC to routinely disclose large-trader information to contract markets for market surveillance purposes with adequate safeguards to protect the information's confidentiality. 1/

AGENCY COMMENTS AND OUR EVALUATION

Most of CFTC's comments deal primarily with dates and recent changes in CFTC's ADP system. CFTC's primary concern was that the use of ADP to analyze surveillance data had increased since our audit was completed and that it was attempting to use ADP to analyze price, volume, and open-interest data. We agree that CFTC is making progress in this area. CFTC's comments are presented in their entirety in appendix XV.

EXCHANGE COMMENTS AND OUR EVALUATION

Chicago Mercantile Exchange

The Chicago Mercantile Exchange discussed our reference to CFTC's proposal to improve exchange large-trader reporting systems. The exchange reiterated its position that CFTC's involvement in this area should be one of

> "oversight, not one of prescribing the collection, processing, and submission of large-trader data, which could ultimately lead to the CFTC's direction of the market surveillance itself."

The exchange stated that effective monitoring can best be achieved through the exchanges. In this context, the exchange stated that its large-trader reporting system is more detailed than CFTC's.

We agree with the Chicago Mercantile Exchange that the exchanges should have primary responsibility for market surveillance; we do not believe CFTC should perform surveillance for the exchanges. Not all exchanges, however, have a large-trader reporting system of the same quality as the Chicago Mercantile Exchange. Since the quality of exchange large-trader data varies, we believe CFTC needs to improve this data so that exchanges can fulfill their self-regulatory responsibilities.

1/Legislative language to authorize this recommendation is in app. XII.

The Chicago Mercantile Exchange commented that we had inappropriately characterized a statement regarding market surveillance made by the exchange's head of market surveillance. In its comments, the exchange stated that while the market surveillance official stated that surveillance is an important marketing tool, effective marketing is only a secondary benefit of aggressive market surveillance but that public confidence in the exchange's markets was the principal benefit of aggressive market surveillance. The statement attributed to the head of market surveillance now reflects the exchange's comments.

Chicago Board of Trade

The Chicago Board of Trade stated that our views on the need for large-trader data are based on an erroneous premise, namely that large-trader position data is required for effective market surveillance. The Board of Trade stated that an effective market surveillance program is one which is sensitive to price distortions and capable of discovering whether price distortions are due to natural or artificial causes. According to the Board of Trade, large-trader data is needed only after it has been determined that price distortions are due to artificial causes.

To obtain large-trader data when it is needed, the Board of Trade stated that it uses computer runs which list gross positions of clearingmembers, grouped by FCM and customer account, to identify large concentrations of positions. It then contacts the clearingmember to get more detailed data. The Board of Trade stated that it also uses CFTC's large-trader reporting system as a second source of large-trader data.

In general, the Board of Trade argued that:

> "Routine large trader monitoring by the exchanges is neither efficient nor effective, especially in light of its limited usefulness for market surveillance purposes."

The Chicago Board of Trade offered several arguments as to why CFTC is in a position to collect large-trader data more efficiently and less expensively than the exchanges. In particular, the Board of Trade stated that:

--CFTC has jurisdiction over FCMs that are not members of exchanges; therefore, CFTC can more effectively enforce its reporting requirements.

--CFTC, because it acts as a centralized source, can more effectively aggregate traders' positions and at the same time ensure the confidentiality of large-trader data.

--CFTC has an existing large-trader system, whereas it would be expensive for the Board of Trade to develop a duplicate system.

We do not believe our views on large-trader data are based on "an erroneous premise." The purpose of market surveillance is to detect incipient market disruptions at the earliest possible moment and to prevent them from developing. If surveillance officials wait until after a distortion becomes apparent and has been verified (by consulting underlying supply and demand data) to take action, the efficiency of the price discovery/hedging functions that futures markets are intended to serve will clearly have been impaired. The price discovered will not be the one a competitive, undistorted market would have produced. Hedgers will have had to commit needed capital to meet margin requirements that they could have used for other purposes in the absence of the price distortion.

Timely large-trader information, in our view, is necessary to conduct effective surveillance. It allows surveillance officials to detect potentially troublesome positions before distortions occur and to contact and work with traders to assure that distortions are prevented. Large-trader data also allows surveillance officials to enforce speculative limits--an additional method for preventing market disruptions. Without an effective large-trader reporting system, speculative limits are, in our view, meaningless.

We recognize the merits of the arguments the Board of Trade has raised regarding why CFTC can collect large-trader data more efficiently and less expensively. We discussed these same arguments, and based on these, we recommended that CFTC expand its August 1980 proposal to examine the potential for CFTC to routinely supply large-trader data to the exchanges in return for a fee.

The Board of Trade disagreed with our attribution to its head of market surveillance of a statement which said, in effect, that the exchange takes a laissez-faire approach toward its markets. We did not intend to suggest that the Chicago Board of Trade takes a laissez-faire attitude toward market surveillance. The head of market surveillance told us that the Board of Trade takes a more laissez-faire attitude toward the futures markets. As evidence of this, he noted that the Board of Trade is more tolerant of price changes (presumably only those due to natural causes) than CFTC. Our characterization of this exchange official's statement now makes clear the Board of Trade's views.

The Commodity Exchange, Inc. (COMEX)

COMEX disagreed with our attribution to its market surveillance director of a statement to the effect that when it needs detailed large-trader data, it contacts CFTC. The exchange stated that it has a reporting system for silver and copper and that it took actions in April 1981 and February 1982 to require uniform reporting requirements and lower the reportable position level from 500 to 250 contracts. The exchange agreed that a large-trader reporting system is an integral part of an efficient market surveillance program.

We did not intend to suggest that COMEX regularly relies on CFTC for all large-trader data. We were aware that the exchange had a reporting system for silver and copper; however, the exchange is quite active in other commodities, for example gold, for which, according to its market surveillance director, there is no large-trader reporting system. The market surveillance director told us that for commodities for which the exchange has no large-trader system or when he needs more detailed data, he contacts CFTC. Consequently, we believe our attribution is correct.

The exchange's comments are presented in their entirety in appendix XVI.

OTHER COMMENTS AND OUR EVALUATION

National Futures Association (NFA)

NFA commented on our discussion of NFA's potential for collecting and disseminating large-trader data to CFTC and the exchanges. NFA stated that it does not and will not have any market surveillance responsibility and that if it were to collect large-trader data it would merely be supplying a service. NFA stated that "while such a service may be feasible at some point in the future," its resources will be initially applied in fulfilling the responsibilities authorized by its articles of incorporation and by CFTC.

NFA also acknowledged the questions raised by exchange and CFTC market surveillance officials regarding (1) whether NFA would be able to run a large-trader system during NFA's early stages of development and (2) whether it would be appropriate for NFA to handle confidential large-trader data for which it has no specific needs.

NFA's comments are presented in their entirety in appendix XVI.

CHAPTER 5

IMPROVEMENTS TO CFTC's REGISTRATION PROGRAM COULD PROVIDE BETTER CUSTOMER PROTECTION

CFTC's program to screen individuals who deal in commodities and to register them has not kept pace with the needs of a changing, growing commodities industry. To protect futures customers in their dealings with commodity professionals, CFTC needs to register these professionals, screen them initially and on a continuing basis to remove unfit and unqualified individuals, and assure that these individuals have a minimum level of competency. To achieve these objectives, CFTC needs to (1) register sales and supervisory personnel of commodity trading advisors (CTAs) and commodity pool operators (CPOs), (2) require FCMs to sponsor associated persons (APs) (employees who solicit or accept customers' orders), (3) fingerprint applicants for registration, (4) periodically check the fitness of existing registrants, and (5) establish proficiency testing. Although CFTC has initiated actions in some of these areas, it has not fully implemented measures to achieve these objectives. For example, a need for essential ADP support capabilities has hampered its efforts to implement AP sponsorship and fingerprinting.

The newly created National Futures Association (NFA) is expected to relieve CFTC of a part of its current registration responsibility. CFTC, however, needs to plan more actively for the transfer of registration and related activities to NFA. Also, CFTC needs to obtain legislative authority to transfer certain registration functions to NFA. Presently, CFTC only has the authority to delegate to NFA registration responsibilities for persons associated with FCMs.

THE PURPOSE AND PROCESS OF CFTC's REGISTRATION PROGRAM

The Commodity Exchange Act requires certain persons who deal in commodities to register with CFTC, which may deny registration if it finds an applicant unfit. For example, CFTC can deny an applicant's registration if the applicant has engaged in any practice prohibited by the act, was convicted of a felony or commodities- or securities-related crime, or has willfully submitted a false or misleading registration application. Under the act, the following parties cannot deal in commodities unless they are registered with CFTC:

--Futures commission merchants (FCMs)--Individuals, associations, corporations, partnerships, and trusts soliciting or accepting orders to purchase or sell any commodity for future delivery.

--Associated persons (APs)--Persons associated with any FCM as a partner, officer, or employee in any capacity that involves (1) soliciting or accepting customers' orders or (2) supervising any person so engaged.

--Floor brokers (FBs)--Persons who may buy or sell futures contracts on the trading floor of the exchange for others.

--Commodity trading advisors (CTAs)--Persons who for compensation or profit advise others directly or in writing on the value of commodities or on trading commodities for future delivery or who issue analyses or reports on commodities for compensation as a part of a regular business.

--Commodity pool operators (CPOs)--Persons engaged in a business, such as an investment trust or syndicate, who solicit, accept, or receive from others funds to trade in commodities for future delivery on a contract market.

The basic objectives of CFTC's registration program are to maintain an accurate record of who is in the commodities industry and to keep unfit individuals from participating in it. CFTC's registration program uses a fitness screening process that checks applicants' names and other pertinent information in their applications against Federal Bureau of Investigation (FBI) and Securities and Exchange Commission (SEC) files.

The Division of Trading and Markets' qualification and registration section carries out the registration program. Registration applications are processed in CFTC's Chicago regional office. After the application and application fee are received, the application is photocopied and key punched for computer storage. Copies of the application are then sent to CFTC headquarters in Washington for forwarding to the FBI. Also, an SEC name file with the applicant's name included is sent, in computer tape format, to headquarters for forwarding to SEC. At the FBI, fitness checks are made to determine if the applicant has a record of arrest, conviction, or some other potential grounds for denial. At SEC, files are checked to determine whether the applicant has committed any securities-related crime or violation. During fiscal year 1981 SEC performed 17,360 fitness checks and the FBI performed 13,382 fitness checks.

If SEC and FBI fitness checks do not uncover any grounds for denying registration, the Chicago regional office is informed and the registration is granted. If the checks reveal information indicating possible grounds for denial, the headquarters staff evaluates the information and, if warranted, begins investigating the individual. Investigations are performed by CFTC staff or by an outside investigative organization if CFTC staff cannot perform the investigation. Until September 30, 1981, outside investigations were performed on a contract basis by the U.S. Secret

Service. The Office of Personnel Management now performs investigations on a contract basis.

Investigation results are evaluated at CFTC headquarters, and if the Assistant Director, Division of Trading and Markets, believes that grounds exist for denying registration, the denial process is started. CFTC has issued an Interpretative Statement Regarding Good Cause Standards for Denial of Registration as a guide for determining whether an applicant should be denied registration. These standards are CFTC's interpretation of its authority to refuse registration under section 8a(2) of the act.

According to headquarters staff, only 10 applicants out of 28,599 have been formally denied registration during the past 2 fiscal years. Another 179 applicants were allowed to withdraw their applications after a CFTC investigation into their fitness. Thus, a total of 189 applicants were excluded from the industry in those 2 years. At the end of fiscal year 1981, 51,682 registrants were registered with CFTC (380 FCMs, 4,403 FBs, 44,337 APs, 1,735 CTAs, and 827 CPOs).

Under the act, registrations are only valid for 1-2 years. To continue to practice, professionals must reapply for registration as follows: an FCM or FB by December 31st of each year, a CTA or CPO by June 30th of each year, and an AP before 2 years after registration. For reregistration (renewal of registration), CFTC does not make fitness checks against FBI or SEC files but relies on the applicant to disclose in his or her application whether he or she has engaged in potentially disqualifying activities since the date of the last registration. CFTC processed 22,740 renewal applications during fiscal year 1981 (355 for FCMs, 3,379 for FBs, 16,982 for APs, 1,332 for CTAs, and 692 for CPOs).

Section 4p of the act provides that CFTC may specify

> "* * * appropriate standards with respect to training, experience, and such other qualifications as the Commission finds necessary or desirable to insure the fitness of futures commission merchants, floor brokers, and those persons associated with futures commission merchants or floor brokers."

Although CFTC has studied this area, it has not established qualification standards.

OUR PRIOR RECOMMENDATIONS CONCERNING REGISTRATION FITNESS AND QUALIFICATION REQUIREMENTS

In 1978 we noted that CFTC needed to significantly upgrade its registration program if the program were to successfully prevent unfit and unqualified individuals from dealing with the trading public. We recommended that CFTC fingerprint applicants to provide a surer means of identifying and screening out unfit individuals. Fingerprinting, which is used in the securities industry, would enable CFTC to better identify individuals whose applications should be denied because of prior criminal activities and would ease CFTC's job of enforcing the registration provisions of the act.

We also recommended that CFTC stop automatically reregistering applicants and instead review the fitness of registrants on a continuing basis. We recommended that CFTC periodically rescreen applicants by using FBI and SEC checks and the information it already collects from exchanges and FCMs concerning disciplinary actions and terminations, since applicants might not voluntarily include derogatory information in their applications.

We also pointed out that CFTC's registration program lacked procedures to ensure that individuals and firms dealing with the trading public were, in fact, registered. Without such procedures CFTC's registration program lacked credibility. We recommended that CFTC perform periodic test checks to ensure that individuals and firms required to be registered are, in fact, registered.

Finally, we noted that CFTC could improve its ability to protect the public by exercising its statutory authority to set qualification and proficiency standards for registrants. With such standards CFTC would be better able to prevent unscrupulous and unqualified individuals from dealing with the trading public. Therefore, we recommended that CFTC establish and enforce qualification and proficiency standards for registrants.

To date, CFTC has implemented one of the above recommendations; it now performs periodic test checks to ensure that individuals and firms required to be registered are, in fact, registered. CFTC has not implemented our other recommendations or any alternate solutions to the problems identified in our 1978 report because of weaknesses in planning and resource utilization. As discussed below, the basis for our 1978 recommendations still remains.

IMPLEMENTING ASSOCIATED PERSON SPONSORSHIP AND FINGERPRINTING HAS BEEN DELAYED BY A LACK OF ESSENTIAL SUPPORT CAPABILITIES

AP sponsorship and fingerprinting have been recognized as ways to assure that individuals seeking registration are fit to work in the commodities industry. However, CFTC had to delay implementing these two requirements because it could not provide the necessary ADP support. To meet its ADP requirements, CFTC recently agreed to share computer facilities with the Environmental Protection Agency. CFTC officials expect this arrangement to meet the new July 1, 1982, target date set for implementing CFTC's AP sponsorship and fingerprinting regulations.

On December 5, 1980, CFTC published final regulations for implementing the fingerprinting and AP sponsorship requirements to become effective July 1, 1981. However, the new regulations were not implemented at that time because the computer facilities necessary to accommodate the additional information that would be generated by these new requirements were not available. Consequently, the Commission voted to defer implementation of the regulations until July 1, 1982.

CFTC's sponsorship regulations will require every AP registered with CFTC to be associated with and sponsored by an FCM. A sponsoring FCM will be required to screen each applicant for registration as an AP and to certify that to the best of the FCM's knowledge, information, and belief, the applicant's application is accurate.

According to CFTC, the new sponsorship requirements will (1) establish an industrywide minimum standard for preemployment evaluation of APs, (2) ensure that all FCMs develop programs that will upgrade APs registered with CFTC, (3) implement fully the provisions of the act, and (4) reduce a regulatory burden by eliminating the present biennial renewal requirement for all APs, substituting registration for as long as the person remains associated with a particular FCM or its agent.

CFTC's fingerprinting regulations will require fingerprinting registrants in all categories. According to CFTC, the fingerprinting requirement is necessary to permit improvements in CFTC's background checks of applicants for registration, to permit positive identification of certain individuals with common names, and to facilitate periodic fitness reviews. CFTC expects that the new requirement will also reduce the number of applications filed by unfit individuals.

In 1978 the Congress granted CFTC the authority to require applicants for registration to submit fingerprints to CFTC along with their applications. In 1978 CFTC decided to implement fingerprinting requirements when it implemented AP sponsorship. According to CFTC registration officials, the new sponsorship and fingerprinting rules will double the paperwork from current levels, and they anticipate that most of the review and checking required will be done by a computer. Because both activities rely upon ADP capabilities, CFTC decided to defer implementation until it obtained a new ADP system.

We discussed CFTC's inability to implement AP sponsorship and fingerprinting with the Director of the Division of Trading and Markets. He told us that the Commission has never given planning and support for a new ADP system for registration a high priority. CFTC cannot implement AP sponsorship and fingerprinting with its present ADP capability because it cannot handle the additional workload, and the division does not have the staff to implement the new requirements without ADP.

When determining the requirements for an ADP system, it is important to include the people who are most directly involved in the present system and the functions and objectives to be served by the new system. CFTC, however, did not coordinate its ADP plans with an important user--CFTC's Chicago registration branch. The registration branch was not involved in defining requirements for a new system.

Furthermore, until after the present Executive Director came on board on July 6, 1981, CFTC did not fully explore alternatives for implementing AP sponsorship and fingerprinting, such as contracting out the processing or entering into a time-sharing arrangement (sharing computer time and storage capability) with another agency. Since then, CFTC has taken steps to resolve its ADP needs by agreeing to share computer time and by starting a detailed system design; however, considerable work remains to be done, including completion of the system design, programing, transferring the data base from Chicago to the Environmental Protection Agency, testing the system, and implementing the system to meet the target date for implementing the new AP sponsorship and fingerprinting rules.

CFTC HAS NOT UPGRADED ITS REGISTRATION PROGRAM BY PERFORMING PERIODIC FITNESS CHECKS

CFTC still does not perform reregistration fitness checks to help guard against unfit persons remaining registered with CFTC. During the reregistration process, CFTC does not screen applicants against FBI and SEC files, as is done during the initial registration process. Instead, CFTC relies primarily on the information in the applicant's reregistration application. Any person familiar with CFTC reregistration procedures could take advantage of the fact that CFTC does not periodically perform checks to update a registrant's fitness. For example, a person who has committed a crime that might render him or her unfit for CFTC registration may not inform CFTC of his or her actions. If CFTC periodically performed fitness checks against FBI and SEC files, any record of illegal activity might be revealed and, if deemed appropriate by CFTC, the revocation or suspension process could be started.

Our 1978 report noted that because CFTC, during renewal, does not (1) screen applicants against FBI and SEC files, (2) consider information in employee termination reports that FCMs must file with CFTC, or (3) consider an applicant's historical record of exchange rule violations, applicants might exclude derogatory information on their applications. To protect against this possibility, we recommended that CFTC periodically perform name and fingerprint checks against FBI files and name checks against SEC files and make the necessary investigations before reregistering applicants.

The need for this periodic screening will be eliminated for APs under CFTC's new sponsorship rules, which would make AP registration end with termination of employment with the sponsoring FCM. APs will apply for registration only when they change employers. The Assistant Director in charge of the registration section told us that the AP sponsorship rules, which place increased responsibility on the sponsoring FCM, will result in updating the fitness information on approximately 86 percent of CFTC's registrants because the AP category is the largest category. For other categories of registrants, however, a continued need exists for the additional measure of protection that periodic spot fitness checks would provide. It would probably not be cost-effective to perform fitness checks each time an applicant applies for reregistration; however, we believe fitness checks performed on a spot check basis could be useful without requiring additional CFTC resources or placing undue pressure on existing registration staff.

PROFICIENCY TESTING HAS NOT BEEN IMPLEMENTED

CFTC has acknowledged that because the trading of futures contracts requires substantial knowledge and is highly complicated, qualification and proficiency standards are needed to help CFTC protect the interests of FCM customers. Nevertheless, CFTC has not implemented a proficiency testing and qualifications requirement for any registrant category. CFTC was granted authority to require proficiency examinations for persons registered as FCMs, FBs, and APs in 1974. In 1976 CFTC's Advisory Committee on Commodity Futures Trading Professionals, chaired by former Commissioner Martin, stated that the level of competence among APs clearly needed to be upgraded. It recommended, by the earliest feasible date, that all new AP applicants be required to pass a proficiency examination as a condition of registration. The agency published proposed rules on proficiency testing of APs in the Federal Register on April 7, 1981, but has not published final rules implementing the testing.

CFTC received nine comment submissions on its proposed rules: three from FCMs, one from a CTA, one from an exchange, one from a futures industry trade association, one from an applicant for registration with CFTC as a futures association pursuant to section 17 of the act, one from a commodity trading publication, and one from a school offering classes in examination preparation and futures trading for prospective futures industry employees. Most commenters strongly supported proficiency testing for APs and believed that the proposed requirement would benefit the public and the industry. Only one commenter, an FCM, opposed the requirement, saying that it would prolong the waiting period for AP registration. Two commenters believed that the benefits derived from increasing the level of professionalism in the industry far exceeded the costs involved. One commenter suggested that CFTC also require testing for CTAs and CPOs.

We believe that all commodity solicitors, advisors, and other individuals who are involved, either directly or indirectly, in influencing or advising the investment of customer funds should be required to pass a test that shows that they have a minimum level of competency regarding commodities.

CFTC has acknowledged in certain reparations decisions that a minimum level of knowledge is needed for all persons giving commodity advice in a fiduciary trust relationship. For example, in one reparations decision we reviewed, involving a registered FCM and one of its APs, the Commission concluded that although it was clear that the registrant's misrepresentation was the result of ignorance, he was a commodity professional upon whom the complainant relied, and, as a fiduciary--an AP giving commodity trading advice--had a duty to know all material market facts which were reasonably ascertainable concerning a customer's trading decision. In another decision involving a registered CTA, the Commission made basically the same claim, but in this case the registrant had taken a training course designed to familiarize him with market mechanics, risks, and strategies. However, the training course did not cover the material on which he had misadvised. This illustrates, in our view, the need for a uniform, comprehensive, industrywide proficiency test.

Both the Deputy Executive Director and the Director of the Division of Trading and Markets told us that in 1978 the Commission decided that developing and administering a test would be more adequately performed by a registered futures association. Therefore, the Commission deferred action on testing until a registered futures association had been authorized. In 1981 CFTC published proposed rules concerning proficiency testing and qualification standards because it did not know if or when a registered futures association would be approved. When it became apparent that CFTC would approve NFA, the proficiency testing issue was again deferred in the expectation that NFA would perform the testing.

NFA's Articles of Incorporation state that NFA will adopt appropriate standards regarding training, experience, and other qualification requirements it deems necessary and appropriate to ensure the fitness of associates. NFA also plans to administer written proficiency examinations for associates. At NFA hearings in June 1981, NFA's President stated that NFA, with Commission approval, could relieve CFTC of much of the clerical burden connected with testing APs. Presently, NFA has not set a definitive timetable for developing and administering a test. Now that NFA has been approved, we believe CFTC needs to encourage NFA to start a testing program soon.

CFTC's proposed rule would enable the testing organization (or NFA) to establish and collect a reasonable examination fee, subject to approval by the Commission, based on the cost of developing and administering the examination program. Several exchanges currently require APs of their member FCMs to pass a written proficiency examination. The fee for this test is approximately $40 per individual and is usually paid by the firm.

CTA AND CPO SALES PERSONNEL NEED TO BE REGISTERED

Neither CFTC's authorizing legislation nor its own rules require the sales personnel of CTAs and CPOs to register with CFTC. Consequently, a potentially large group of individuals working in the commodities industry does not directly fall under CFTC's oversight. CFTC, recognizing the need to bring this group into its registration program, has recently proposed rules requiring that they be registered.

A salesperson is anyone who solicits managed accounts (in the case of CTAs) or investment of funds in commodity pools (in the case of CPOs). The CTA and CPO registrant categories have both experienced considerable growth since 1978. The schedule below shows the number of registrants at the end of fiscal years 1978 to 1981.

	FY 78	FY 79	FY 80	FY 81
CTAs	720	869	1,305	1,735
CPOs	482	532	752	827

CTAs' and CPOs' operations have also expanded and diversified; therefore, they now play a larger and more significant role in the industry. The trading public is placing increased reliance on professional managers to manage their accounts and on commodity pools to invest their funds. One CFTC registration official told us that CTAs and CPOs have a greater impact on the industry now than ever before because they are handling an increased amount of funds for the trading public.

Because of the increased volume of business handled by CTAs and CPOs, the number of CTA and CPO salespersons and supervisors has also increased. These salespersons solicit business and funds from the trading public like APs. As a result, we believe they need to be subject to the same general registration requirements, such as fitness checks.

CFTC has recognized the need to register these individuals. As a result, it has proposed a rule that would specify the terms by which any individual who solicits customers on behalf of a CTA or a CPO, or who supervises any person so engaged, must register with CFTC as a CTA. The rule further provides that it is unlawful for any CTA or CPO to allow any individual to solicit customers on its behalf if the CTA or CPO knows or should know that the individual was not registered as a CTA. Persons already registered are exempt from this requirement. The Commission voted on December 22, 1981, to publish the proposed rules in the Federal Register. We support CFTC's proposed rules. [1]

QUESTIONS NEED TO BE RESOLVED CONCERNING REGISTRATION FUNCTIONS THAT WILL BE ASSUMED BY A REGISTERED FUTURES ASSOCIATION

CFTC and the Congress need to resolve questions about the role that a registered futures association will play in registration. CFTC needs to determine the appropriate role of an association in meeting the objectives of the act and CFTC and to identify the best method to achieve these objectives. The Congress needs to decide what registration functions it wants CFTC to retain and what functions it will allow to be transferred to a registered futures association. The Congress will need to amend the Commodity Exchange Act to make possible the transfer of some of these registration functions to NFA or to another registered futures association (see app. XII).

Need for more active CFTC involvement in planning and preparing for NFA's registration role

CFTC has done little since NFA was incorporated in 1976 to identify and plan for the registration functions and related activities it will share with NFA; it has done little to define its future oversight role regarding NFA; and it has not determined the information it will need to carry out this role or how it will receive needed registration information from NFA. According to the Deputy Director, Division of Trading and Markets, the division did not believe its staff should spend time working out specific areas that NFA would assume because NFA's future capabilities were uncertain. To ensure that the transfer of certain registration functions from CFTC to NFA will be orderly and efficient, we believe CFTC needs to actively prepare for the transfer. First, CFTC and NFA need to determine NFA's role in registration. CFTC also needs to determine what its oversight role will be and how it will be carried out.

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[1] Since our review, CFTC has submitted to the Congress its proposed amendments to the Commodity Exchange Act. One of CFTC's legislative proposals would require the registration of principals and employees of CPOs and CTAs as associated persons of the CPOs and CTAs. If enacted by the Congress, this provision would supplant the proposed CFTC rule change to register these individuals as CTAs.

Currently the only registration function CFTC plans to transfer to NFA and that is specifically authorized by the act is AP registration. However, CFTC does not know if or when NFA will assume this function.

During a November 10, 1981, Commission meeting, the possibility of changing the registration periods for certain categories of CFTC registrants was discussed. The Director, Division of Trading and Markets, suggested that a decision regarding the duration of AP registration should not be made at that time because of uncertainties about whether and when NFA would take over AP registration. Consequently, the Commission has delayed any action regarding CFTC's registration renewal policies. This discussion shows that because CFTC does not have a clear picture of the registration functions that will be assumed by NFA, it has had to defer implementing changes to the registration program.

In 1979 the Commission announced a policy, based on a Trading and Markets Division recommendation, which set forth the requirements for approval of a registered futures association. These included, among other things, the requirement that an applicant association provide a plan of activity and that it demonstrate that it has or will have the necessary resources for implementing a complete self-regulatory program. The statement also noted that the specific functions of the organization should include registering and testing industry personnel. However, on September 22, 1981, the Commission approved NFA as a registered futures association without knowing what specific registration functions NFA would undertake, when it would undertake them, or how it would perform them. We believe the Commission's change in position from the one it adopted in 1979, though it accomplished a very important goal--creation of a self-regulatory organization--was not the optimal position to take because it left the important questions discussed above unanswered.

CFTC has not looked at its role regarding NFA. The Executive Director made a proposal to the Commission in the fall of 1981 to establish an advisory committee on self-regulation to work with NFA to determine its appropriate role in registration. However, this proposal was not adopted. Such an advisory committee would have been a step in the right direction for working with NFA on the transfer of registration functions.

We talked with the Executive Director and other CFTC officials about how CFTC intends to oversee an NFA registration program. They told us that the scheme of CFTC's oversight has not been worked out yet because CFTC does not know what NFA will do. They also told us that CFTC has not determined what information it will need for oversight or how it will get this information from NFA.

We believe CFTC needs a strong oversight role. One form of CFTC oversight could be through an appeal process for NFA registration decisions. CFTC plans to have a process by which any NFA decision regarding the granting, denial, or revocation of registration can be appealed to CFTC. However, two senior attorneys in CFTC's Office of General Counsel believe that if registration denial and revocation authority is transferred to NFA, an appeal to CFTC of an NFA registration action is not guaranteed under the present language of the act. They believe the Congress needs to clarify the right of an applicant/registrant to appeal a particular NFA decision to CFTC. We agree that the Congress needs to establish specific authority for a party to appeal an NFA registration decision to CFTC. We believe CFTC needs to have the power to review any adverse NFA registration decision or action so that it can adequately oversee NFA's registration program and guarantee due process in registration, denial, and revocation matters.

Without knowing what registration functions NFA will assume or when it will assume them, CFTC is unable to adequately plan for its registration role. CFTC has been unable to determine the staff resources needed to perform those registration functions that are not transferred to NFA and for overseeing NFA's registration program. Several factors will determine the resources needed--what specific functions NFA assumes, how the appeal process will work, the number of appeals CFTC receives, and the degree of CFTC oversight needed. These questions must be answered before any CFTC functions are transferred to NFA.

Legislative changes are needed to transfer certain registration functions to a registered futures association

The Director, Division of Trading and Markets, told us that effective industry self-regulation depends, in part, upon the ability of a registered futures association to screen individuals applying for entrance into the commodities industry. However, NFA, or any other registered futures association that the Commission may approve, will need congressional authority to assume the registration function for FCMs, CTAs, CPOs, and FBs and other categories that may be established. The language in section 4k of the act is very specific regarding a registered futures association taking over the registration function for APs, so specific that it presently would appear to exclude the possibility of CFTC's transferring to a registered futures association the registration responsibility for FCMs, FBs, CTAs, and CPOs. CFTC officials, including the Executive Director and present Director of Trading and Markets, agreed that under the present wording of the act, CFTC would only be able to transfer the responsibility for AP registration.

The act allows CFTC to further prescribe by rules and regulations that, in lieu of CFTC-administered examinations, futures associations registered under section 17 of the act may adopt written proficiency examinations to be given to applicants for registration as FCMs, FBs, and those persons associated with FCMs or FBs. Present law does not expressly subject CTAs and CPOs to the proficiency examination requirement. Likewise, any new categories of registrants, such as APs of CTAs and CPOs, are not subject to such a requirement. We believe that any individual involved either directly or indirectly in influencing or advising on the investment of commodity customers' funds should meet minimum qualification standards through examination, training, experience, or a combination of these.

Section 8a(1) of the act currently provides that CFTC may require registration applicants to be fingerprinted. Section 17(f)(2) of the Securities Exchange Act of 1934 has been construed by CFTC to allow the National Association of Securities Dealers and the national securities exchanges to collect the fingerprints of their members and submit those fingerprints to the FBI for identification and processing. Therefore, section 8a(1) can probably be similarly construed to allow a registered futures association to perform the same function. If, however, the Congress believes that express authority needs to be provided to accomplish this, the act needs to be amended to allow a registered futures association to collect the fingerprints of its members and submit the prints to the FBI for identification and processing.

CONCLUSIONS

In our view, CFTC needs to create a more comprehensive and effective registration program. Although CFTC has tried to take actions to improve its registration program, we found that insufficient preparation has hampered its efforts. As a result, CFTC's registration program has not kept pace with the rapid growth and development of the commodity futures industry. CFTC has long had authority to improve its registration program through periodic fitness checks and proficiency testing. However, it has not made either of these improvements. The new AP sponsorship rules in effect will call for new fitness checks for APs when they change firms but make no provision for other categories of registrants. Proposed rules for proficiency testing were published in April 1981, but final rules have not been issued since CFTC expects that the newly authorized NFA will perform proficiency testing.

Since its 1978 reauthorization, CFTC has had clear legal authority to require the fingerprinting of applicants for registration, but because essential ADP support has not been available, CFTC has been unable to use this mechanism for improving registration safeguards. Recent CFTC actions will provide the ADP capability through a time-sharing arrangement with another government agency. Both fingerprinting and AP sponsorship might now be operating had this alternative been considered earlier.

CFTC does not presently register the sales and supervisory personnel employed by CTAs and CPOs, a rapidly growing and increasingly important segment of the industry. Because of this, there is less than complete registration coverage of the industry.

In our view, CFTC has not answered necessary questions concerning the role that a registered futures association will play in registration. Specifically, it has not identified the particular registration functions that NFA could and should assume once it begins operating. CFTC has taken the position that it cannot require NFA to identify specific areas it intends to take over, but it can make sure that no function is transferred to NFA until NFA submits a detailed plan stating how it expects to perform each function. We believe that it is appropriate, and in fact necessary for CFTC to play a more active and prescriptive role in formulating a registration program.

Legislative changes are needed to transfer certain registration functions to a registered futures association. Presently, the act specifically provides that CFTC may transfer to a registered futures association its registration responsibility, including testing, only for APs.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To improve CFTC's registration process, we recommend that the Commission:

--Implement by the July 1, 1982, target date AP sponsorship and the fingerprinting of registration applicants.

--Review the fitness of registrants against SEC and FBI files on a spot check basis during reregistration.

--Encourage NFA to expeditiously establish proficiency testing and qualification standards for CFTC registrants.

--Revise its rules to require the registration of sales and supervisory personnel of CTAs and CPOs. 1/

--Develop a plan for NFA's takeover of registration functions. This plan should be preceded by an analysis of the role NFA can and should play in registration, CFTC's residual role in registration, how CFTC will perform oversight of NFA registration activities, and the information that will be needed to perform this oversight.

1/CFTC's own legislative proposal in this area would, in our view, constitute a satisfactory alternative, if implemented.

RECOMMENDATIONS TO THE CONGRESS

We recommend that the Congress: 1/

- --Amend section 8a and insert a new subsection to allow applicants/registrants to appeal to CFTC any registration decision made by a registered futures association.
- --Amend sections 4f and 4n of the act to authorize a registered futures association to register FCMs, CTAs, CPOs, and FPs in lieu of registration with CFTC.
- --Amend section 4p of the act to allow for the testing of CTAs and CPOs and also amend section 4p to allow any registered futures association to develop and administer such tests for all categories of CFTC registrants upon Commission approval.
- --Clarify section 17(b)(4)(E) of the act to ensure that any registered futures association (upon approval by the Commission) can collect the fingerprints of its members and submit those fingerprints to the FBI for identification and processing.

AGENCY COMMENTS AND OUR EVALUATION

CFTC stated that it has already taken steps to implement almost all of our recommendations regarding the Commission's registration function. CFTC's comments are presented in their entirety in appendix XV.

Although CFTC stated that it has taken steps to implement almost all of our recommendations, its comments did not identify or discuss the steps taken. Our report recognizes actions taken by CFTC to implement our recommendations concerning AP sponsorship, fingerprinting, and registration of CTA and CPO sales and supervisory personnel. However, most of the actions taken by CFTC have not resulted in the actual implementation of revised procedures for the registration program because insufficient preparation has hampered its efforts. Also, CFTC has not taken any action to implement our recommendations to (1) review the fitness of registrants against SEC and FBI files on a spot check basis during reregistration and (2) develop a plan for NFA's takeover of registration functions.

Regarding our recommendation that proficiency testing and qualification standards be established for CFTC registrants, CFTC has published proposed rules on the proficiency testing of APs

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1/Legislative language to authorize these recommendations is included in app. XII.

but has not published final rules implementing such testing. CFTC has deferred implementation of proficiency testing in the expectation that NFA would perform the testing. We believe, therefore, that CFTC should adopt our recommendation and encourage NFA to expeditiously establish proficiency testing and qualification standards for CFTC registrants.

OTHER COMMENTS AND OUR EVALUATION

The Department of Justice provided detailed comments on our draft report concerning the impact on competition in the marketplace of an expanded role for industry self-regulatory organizations. The Department stated that it doubted that NFA would be effective and efficient and was concerned that NFA, in part because it is a mandatory membership organization, is likely to result in reduced competition within the commodity futures industry. The Department also said that it was troubled by our implicit acceptance of NFA given the fundamental competitive questions raised by CFTC's approval of NFA. The Department believes that the issue of mandatory membership-registered futures associations encompassing the entire industry should be reevaluated.

Our review of the Department's comments indicates that the comments appear to be a restatement of prior objections the Department has made regarding NFA. The Department has offered these objections previously both to the Congress and to the Commission. In 1978, after the Department opposed NFA's first application as a registered futures association, because of NFA's compulsory membership requirement, the Congress amended the Commodity Exchange Act to permit CFTC to require membership in a registered futures association if CFTC determined it was necessary or appropriate. In July 1981, the Department submitted detailed comments to CFTC relative to NFA's March 1981 application for approval as a registered futures association. Again, the Department voiced its objection to NFA's compulsory membership requirement. CFTC approved NFA as a registered futures association in September 1981 with a compulsory membership requirement. Our review did not include an evaluation of NFA's registration statement or CFTC's actions relative to its approval of NFA as a compulsory membership registered futures association.

We did question CFTC's rationale for approving NFA without NFA having developed a plan of activity for assuming various CFTC functions. Because the Department of Justice's objections had been raised to, and acted upon by, both the Congress and CFTC, we considered the matter closed. The Department's comments are presented in their entirety in appendix XVI.

CHAPTER 6

CFTC NEEDS TO ALLOCATE AUDIT AND FINANCIAL SURVEILLANCE RESOURCES MORE EFFECTIVELY

An important CFTC function is conducting audit and financial surveillance of commodity exchange activities and records to detect and deter practices that could result in loss of customer funds. CFTC shares this responsibility with the exchanges, which establish and enforce financial requirements for their members. The exchanges' share of this work is, in turn, monitored by CFTC. We found that CFTC can allocate its audit and financial surveillance resources more effectively by shifting certain additional responsibilities to the exchanges and to NFA when it begins operation. Such a reallocation could enable CFTC to reduce its own direct audit workload and improve its performance of the audit and surveillance functions for which it would retain primary responsibility.

CFTC PERFORMS DIRECT AUDITS AND MONITORS EXCHANGE AUDIT AND FINANCIAL SURVEILLANCE PROGRAMS

CFTC carries out its financial surveillance by periodically monitoring certain FCM activities and periodically auditing FCMs. These audits are of two general types--full financial audits and segregation audits. A full financial audit covers all financial aspects of an FCM's operation and determines whether the FCM is complying with CFTC's minimum financial, segregation, and recordkeeping requirements. Segregation audits verify compliance with CFTC's segregation requirements only (that is, ascertain that customer funds are properly segregated from the FCM's own funds). CFTC also performs limited scope examinations that cover only selected aspects of FCMs' operations, such as recordkeeping, capital computations, or margin requirements.

As of September 30, 1981, 380 FCMs were registered with CFTC, 297 of which were members of at least one commodity exchange, leaving 83 that were not members of any exchange. During fiscal year 1981, CFTC performed 300 audits of FCMs, 150 of members and 150 of nonmembers. The 150 member audits were performed on 122 of the 297 member FCMs, and the 150 nonmember audits were performed on 37 of the 83 nonmember FCMs.

CFTC also oversees exchanges' audit and surveillance activities. Each commodity exchange is required to enforce FCM compliance with established minimum financial and related reporting requirements for its members. CFTC oversees how exchanges implement their audit and financial surveillance programs as part of its program for monitoring exchange compliance with self-regulatory responsibilities outlined in the act and CFTC's regulations. CFTC is also responsible for providing financial surveillance over nonmember FCMs. Additionally, FCMs must have their financial statements audited annually by an independent public accountant. CFTC reviews these audit reports.

CFTC's AUDIT RESOURCES COULD BE BETTER UTILIZED

We found that CFTC was devoting substantial audit resources to audits of member FCMs rather than relying on the exchanges to audit their own members. Consequently, the audit resources available for auditing nonmember FCMs and CPOs and for overseeing the exchanges were reduced, with the result that poorer coverage in these areas leaves open the higher risk of customer losses. We also found that CFTC has not developed a plan for transferring certain audit functions to NFA or provided independent public accountants with audit guidelines for performing FCM audits.

CFTC needs to rely more on exchanges to audit member FCMs

CFTC amended its regulations in 1979 to make the exchanges responsible for auditing member FCMs in order to enhance industry self-regulation, to relieve the agency of routine direct audit responsibility for member FCMs, and to allow CFTC to assume more of an oversight role. However, as the chart below shows, CFTC continues to perform a substantial number of audits of member FCMs. If CFTC were to assume more of an oversight role and rely more on the exchanges to audit member FCMs, it could then shift its resources to the auditing of nonmember FCMs and CPOs and to increased monitoring of exchanges and other participants in the commodities industry.

	Audits performed		
	1979	1980	1981
Member FCMs:			
Full financial audits	9	12	10
Segregation audits	37	21	14
Limited scope audits	112	130	126
Total	158	163	150
Nonmember FCMs:			
Full financial audits	35	16	16
Segregation audits	15	14	13
Limited scope audits	65	43	121
Total	115	73	150
Total	273	236	300

The audit and financial review unit in CFTC's Division of Trading and Markets enforces the segregation, recordkeeping, and minimum financial requirements of the act and CFTC's regulations. The unit's primary purpose is to prevent the avoidable loss of customer funds.

CFTC told us that it recognizes the importance of frequently auditing and monitoring nonmember FCMs and has taken steps to increase its audit coverage of nonmember FCMs. In December 1980 CFTC started requiring nonmember FCMs which hold customer funds to contact CFTC's audit staff every business day to report their segregation calculations and to file a written segregation report weekly. To the extent possible, CFTC's audit staff attempts to visit each nonmember FCM with over $1 million in customer funds at least once each month to perform a limited scope audit.

Exchanges, as self-regulatory bodies, are required by section 5a(8) of the act to enforce all of their rules, bylaws, regulations, and resolutions that CFTC has approved. Exchange enforcement of these rules is the key to the self-regulation process that the Congress envisioned when it established CFTC. Regulation 1.51 requires that exchanges must maintain a continuing affirmative action program to enforce their rules. CFTC's regulations require each exchange to have a program for performing onsite examinations of the books and records of member FCMs. CFTC's guidelines for developing these programs state that the exchange should perform a complete financial compliance audit at least once every other year. Other types of audits to be performed include margin, debit/deficit, and limited scope financial compliance audits. CFTC performs similar audits of nonmember FCMs. CFTC also performs audits of member FCMs to (1) verify how well the exchanges have carried out their surveillance of member FCMs, (2) perform audit steps not usually performed by exchanges, or (3) conduct audits dictated by special circumstances.

CFTC has stated that with the exchanges assuming responsibility for monitoring the financial condition of their members, it has been able to devote more resources to monitoring nonmember FCMs and reviewing the exchanges' monitoring activities. In fact, CFTC's 1981 annual report states that the exchanges' uniform minimum financial rules and their financial rule enforcement programs have enabled the Division of Trading and Markets to concentrate more on nonmember FCMs and CPOs. Although CFTC has increased its audits of nonmember FCMs, it has not measurably changed the number of audits it has performed of member FCMs, as the table on page 76 illustrates.

We recognize that CFTC needs to audit a limited number of member FCMs on a spot check basis to verify how well the exchanges have carried out their surveillance of member FCMs and to perform audit steps not performed by the exchanges. However, CFTC does not need to audit as many member FCMs as it did in fiscal years 1980 and 1981, when it audited 61 percent of member FCMs, to carry out this verification. By performing a large number of audits of member FCMs, CFTC is negating the intent of the revised regulations.

Nonmember FCM compliance problems

Nonmember FCMs have been the cause of a disproportionate share of compliance problems. All of the losses of customer funds have been with nonmember FCMs. Since 1974, 24 FCMs have gone out of business, placing about $17 million of customer funds in jeopardy. Actual losses, however, have been much less than $17 million due to the industry's efforts to reimburse customers. In 1980 alone, the financial problems of five FCMs, all of which were nonmember FCMs, placed more than $6 million of customer funds in jeopardy. Three of these firms have gone into bankruptcy and the other two are in receivership. For most of these latest financial failures, CFTC auditors had made audits and had found that the FCMs generally were in compliance with minimum financial requirements and that customers' funds were properly segregated. One of these financial failures occurred only a little more than a month after a CFTC audit showed the FCM meeting minimum capital and segregation requirements.

We do not know what actual losses will be incurred by the customers of these five FCMs. CFTC's Chief Accountant told us that the principals of the two FCMs in receivership (which placed about $600,000 of customers' funds in jeopardy) are under court order to make full restitution to the firms' customers. The Chief Accountant also told us that for one of the FCMs that is in bankruptcy, a settlement is expected of about 75 cents on the dollar of customer funds in jeopardy (about $2 million).

Fifty-eight percent of the audits CFTC performed during the past 2 fiscal years were of member FCMs. CFTC's Chief Accountant told us that although the number of audits was higher for member than nonmember FCMs, more audit resources were devoted to auditing nonmember FCMs than member FCMs. He estimated that approximately 60 percent of CFTC's auditing resources were devoted to auditing nonmember FCMs.

Not all nonmembers audited

During the past 2 years, 223 audits were performed on nonmember FCMs, including 27 segregation audits, 32 general or full financial audits, and 164 limited scope audits. However, not all nonmember FCMs were audited by CFTC during the past 2 years. In fact, as of September 30, 1981, 33, or 40 percent, of the 83 nonmember FCMs did not receive any type of CFTC audit.

CFTC's procedures for selecting FCMs to be audited uses a priority system whereby all FCMs are grouped into four priority categories. The objective of the priority system is to ensure that registrants are given the proper amount of audit coverage.

The lowest priority requires that each FCM be visited at least once every 2 years. The next higher priority requires that the FCMs assigned this rating be audited at least annually. CFTC, in commenting on our draft report, stated that the protection of customer funds is by far the most important reason for conducting financial audits of FCMs. Therefore, firms with no customer funds will always constitute the lowest audit priority. Of the 33 nonmember FCMs not receiving an audit during the past 2 fiscal years, only 1 was classified in the lowest priority (an audit each 2 years), 26 others were classified as requiring an audit at least annually, and the remaining 6 were classified as requiring an audit at least once each 6 months.

Both the Director, Division of Trading and Markets, and the Chief Accountant contend that CFTC does not audit FCMs that do not hold customer funds because this would not be a wise use of its audit staff and because most of the nonmembers that are not audited probably did not have customer funds. None of the 33 nonmember FCMs not audited by CFTC in the past 2 fiscal years were holding customer funds as of September 30, 1981. Although we agree that CFTC should place its primary emphasis on auditing FCMs with customer funds, CFTC also has a responsibility for ensuring that FCMs meet all of their minimum financial requirements, not only those that relate to customer funds. FCMs without customer funds are still required to meet CFTC's capital requirements to remain registered. FCMs must also maintain accurate records and file periodic financial statements.

CFTC does not believe its audit coverage of nonmember FCMs has been inadequate. CFTC has pointed out that although it may not have audited all nonmember FCMs, these FCMs were audited each year by an independent public accountant and that the FCMs also filed quarterly financial reports which were thoroughly reviewed by CFTC's audit staff. We agree that a certain amount of monitoring can be performed through reviews of financial statements; however, such reviews are not a substitute for onsite audits. As CFTC has pointed out to the exchanges, sufficient, competent, evidential matter should be obtained through inspection and observation to afford a reasonable basis for determining if minimum financial and related regulations are being complied with.

CFTC has stated that FCMs without customer funds will always constitute the lowest audit priority. However, as noted above, only one of the 33 nonmember FCMs without customer funds that was not audited by CFTC during the past 2 years was assigned the lowest audit priority. It should be noted that there were 17 other nonmember FCMs not holding customer funds as of September 30, 1981, that were audited by CFTC during the past 2 fiscal years. The audits of 12 of the 17 firms disclosed deficiencies significant enough to cause CFTC to send either a warning or compliance letter or take enforcement action. Our review of the compliance and/or warning letters on file for some of these 17 firms indicate that the firms had been cited for violating various financial and recordkeeping requirements, including being undersegregated and undercapitalized, failure to file required financial statements, and inaccurate computation of adjusted net capital.

CFTC has stated that it recognizes the importance of auditing and monitoring nonmember FCMs on a frequent basis and that it has increased its audits of nonmember FCMs. During the first 4 months of fiscal year 1982, CFTC conducted 76 FCM audits of which 55 (72 percent) were of nonmember FCMs.

CFTC needs to do more audits of CPOs

Resources that would be made available if CFTC were to perform fewer audits of member FCMs could also allow the agency to devote more attention to other areas of the industry that have not received much surveillance in the past--such as CPOs. The number of CPOs has grown substantially over the last 2 years, from 532 registered at the end of fiscal year 1979 to 827 registered at the end of fiscal year 1981, an increase of 55 percent. Although CFTC's annual report for 1981 states that CFTC has used some of the resources made available since exchanges assumed audit responsibility for auditing member FCMs to audit CPOs, a significant increase has not occurred in the number of CPOs audited. CFTC performed 57 CPO audits in fiscal year 1980 and 72 in fiscal year 1981. The 72 CPO audits in fiscal year 1981 meant that only one in every 11 CPOs was audited by CFTC, which is less than 9 percent of all CPOs.

The Director of CFTC's Division of Trading and Markets told us that there have been many problems recently with CPOs and that warning letters have been sent to CPOs on 50 percent of the audits performed. A warning letter is sent when an audit discloses significant violations of minimum financial, segregation, and recordkeeping requirements.

A CFTC report on one of the CPOs CFTC audited in 1980 showed that during an 11-month period the CPO received more than $900,000 from pool participants and used most of those funds to pay the president of the firm, pay commissions to salespeople, and to finance the firm's own business. CFTC's report also showed that more than $70,000 was paid as dividends to participants even though the firm only earned about $14,000. CFTC auditors referred their findings to the Division of Enforcement, which filed an injunctive action against the firm and its president. As part of the settlement of this case, a permanent receiver has been appointed to marshall the firm's assets. The firm's president has been indicted for commodity pool fraud as well as mail and wire fraud.

CPO operations have expanded and diversified. As a result, the trading public is placing increased reliance on commodity pools to invest their funds. In 1981 CFTC implemented revised rules governing the operations and activities of CPOs. These rules establish disclosure, periodic and annual reporting, and recordkeeping requirements. The revised rules seek to ensure that CPOs deal fairly with their customers and maintain adequate records of those dealings. They will also facilitate CFTC's inspections of CPOs.

According to a CFTC staff document, during each of the past 3 years, 37 percent of the CPOs registered have failed to renew their registrations with CFTC. Given the (1) rapid turnover of those registered in this category, (2) the number of CPO audits that have resulted in violations of minimum financial, segregation, and recordkeeping requirements, and (3) CFTC's revised rules on CPO operations, it appears that CFTC needs to increase its surveillance of these individuals. Although some surveillance of CPOs is provided by the Division's front office audit unit, these reviews are intended primarily to evaluate the nonfinancial activities of a firm, such as its sales, marketing, and account management practices, rather than its financial operations.

A CPO's financial operation is monitored by CFTC's audit and financial review unit. In fiscal year 1981 approximately 3 staff years were used to conduct the 72 CPO audits the unit performed. If this low level of auditing continues, this large and growing segment of the commodities industry will be inadequately covered. The branch chief of the audit and financial review unit in CFTC's New York regional office told us that recently his audit staff had been spending about 75 percent of its time dealing with CPOs, usually on a crisis basis with little routine surveillance. He indicated that he could use another 15 auditors just to routinely audit the CPOs in his region.

CFTC informed us that it recognizes the necessity of conducting more audits of CPOs and has increased its audits of CPOs in the first 4 months of fiscal year 1982. CFTC completed 37 financial audits of CPOs during the same period. At this rate, 111 financial audits of CPOs will be completed during fiscal year 1982. This will represent a more than 50-percent increase over fiscal year 1981. Also, the staff hours being devoted to CPO financial audits is twice the level of fiscal year 1981.

A plan for transferring various audit functions to a self-regulatory organization needs to be developed

The additional resources needed to provide for more audits of commodity firms are not readily available considering current CFTC budget limits. Additional audit capability will be available, however, through NFA. CFTC needs to develop a plan that will identify the specific audit functions that will be transferred to NFA and establish a priority system for the transfer of each audit function.

One of the functions that NFA is expected to perform is the audit and financial surveillance of nonmember FCMs. This function is presently the sole responsibility of CFTC. According to the CFTC staff document dated September 15, 1981, recommending that the NFA be approved, the transfer of audit responsibility for nonmember FCMs to NFA is expected to provide an extension of CFTC's surveillance of the financial practices of FCMs. According to this staff document, NFA's regulatory program is designed to fill a gap that currently exists in commodities self-regulation. CFTC noted that NFA is not intended to replace CFTC's customer protection responsibilities but to complement those duties by providing a vehicle through which commodity firms and professionals handling customer accounts will be subject to binding, uniform ethical and financial standards.

In the staff document recommending approval of NFA, CFTC's Division of Trading and Markets stated that:

> "The Commission believes that the commodities industry is not only prepared to assume, and capable of exercising, self-regulatory responsibility with respect to the activities of industry participants, but also better equipped to devote the resources necessary to reduce significantly the considerable number of customer abuses which have occurred in the absence of effective self-regulation."

The document also noted that as NFA implements its regulatory programs, CFTC will be able to reallocate portions of its staff resources from direct auditing functions that it now performs to other priorities. Assuming that NFA can develop a comprehensive audit and financial surveillance program, CFTC can reduce its direct audit role and assume an oversight role. The Deputy Director, Division of Trading and Markets, and the Chief Accountant informed us that they will oversee NFA in the same manner that they now oversee the exchanges' performance of financial surveillance of member FCMs.

As noted in chapter 5, the Commission in 1979 adopted a policy that for a registered futures association to be approved, one of the requirements it had to meet was that it would provide a plan of activity and that it also demonstrate that it has or will have the necessary resources for implementing a complete self-regulatory program. One of the functions noted that should be performed by a registered futures association is financial auditing. However, CFTC approved NFA in September 1981 without knowing what specific audit functions it would perform or how the functions would be performed. NFA's registration statement specifically provides that NFA will assume audit responsibility for nonmember FCMs. It also alludes to other audit functions that NFA may assume in the future. CFTC needs to work with NFA in developing a plan that identifies the specific audit functions that will be transferred to NFA along with a timetable for their transfer.

CFTC performs various types of audits of FCMs and CPOs, reviews FCM financial statements and audits performed by independent public accountants, and audits exchange clearinghouses. Many, if not all, of these audit and surveillance activities could be assumed by NFA. We believe CFTC needs to take a more active role in identifying what specific audit functions will or could be assumed by NFA and should work with NFA to establish a timetable for the orderly transfer of these functions. Since CFTC has overall responsibility for assuring that customer funds are properly safeguarded, we believe CFTC and NFA should jointly consider which audit functions would best be performed by NFA and which audit functions should be retained by CFTC. If CFTC were to work with NFA in identifying areas to be transferred, this would not only enhance the prospects for a successful transfer of audit functions but would also enable NFA to better plan for the establishment of its audit staff capability.

Since CFTC has had sole responsibility for auditing nonmember FCMs and has overall responsibility for assuring the protection of all customer funds, it is in the best position to advise NFA on how to develop and implement an acceptable audit program for auditing not only nonmember FCMs but also any other industry participants for which NFA will assume audit responsibility at some future date. Since CFTC will be reviewing how well NFA carries out its audit activities, it would be advisable that CFTC work with NFA in developing an audit and surveillance program that will meet CFTC's requirements for a self-regulatory organization. As noted in the discussion starting on the next page, we concluded that CFTC should have provided the exchanges with more specific guidance on the development of their audit and financial surveillance programs.

Audit guidelines have not been developed for independent public accountants

CFTC amended its regulations in 1978 to require that FCMs have their financial statements examined annually by an independent public accountant for the purpose of rendering an opinion on the financial statements. This action was taken in response to recommendations made by us in 1975 and 1978 that CFTC shift a greater portion of the burden of auditing FCMs to the industry. We also recommended that to assist the public accountants, CFTC should provide them with detailed guidelines for conducting audits of FCMs. CFTC has not yet issued these guidelines.

When CFTC changed its regulations to require annual financial statement audits by independent public accountants, it also established criteria for computing FCM compliance with certain minimum financial requirements and established standards for the qualifications and reports of accountants. At that time, CFTC noted that accountants should be aware that to conduct an audit under CFTC's rules, they must be familiar with the act and CFTC rules and regulations, in particular with segregation, recordkeeping, and minimum financial requirements applicable to FCMs.

The criteria mentioned above serve as guidance for the public accountant for determining if the FCM is meeting the net capital requirements set out in the regulations. However, additional guidance is needed for other areas in financial statement audits, such as the review of segregation records. The public accountant is also required to submit, along with the financial statements, a report of material inadequacies found. Although the public accountants are expected to use generally accepted auditing standards, we believe that additional specific audit guidelines would help them in auditing FCMs.

The need for audit guidelines is demonstrated by the fact that several FCMs requested that the American Institute of Certified Public Accountants (AICPA) develop such guidelines. In 1979 AICPA's auditing standards subcommittee on commodity futures trading began developing audit guidelines for the commodities industry. Although CFTC has had a few general discussions with AICPA subcommittee members, it has not been involved in developing the audit guidelines. The chairman of the AICPA subcommittee told us that CFTC will be asked to comment on the guidelines after the subcommittee develops them.

AICPA originally had hoped to have a draft of the audit guidelines completed by October 31, 1980, but they have not yet been completed. The former AICPA subcommittee chairman told us that the subcommittee had hoped to meet for 2 days in October 1981 to complete a first draft of the guidelines. The meeting did not take place, however, reportedly because of a change in the chairmanship of the subcommittee effective November 1, 1981. The new chairman told us on November 20, 1981, that it would be at least a year before a draft of the guidelines will be ready for comment.

We believe CFTC needs to work with the AICPA subcommittee to issue these long-delayed audit guidelines as soon as possible. We first recommended the development of such guidelines in 1975 and again in 1978, but CFTC did not implement our recommendations. When CFTC learned that AICPA was developing audit guidelines, it apparently decided not to develop its own guidelines. Since AICPA has been working on its guidelines since 1979 and is not expected to have a draft of the guidelines ready until late 1982, we do not believe CFTC should continue this approach. CFTC has stated that the guidelines should be developed by the accounting industry. The chairman of the AICPA subcommittee also believes that the development of the guidelines is an industry matter. However, the industry has been working on these guidelines since 1979 and will not have a draft of the guidelines ready for CFTC's review and comments until late 1982. We believe that since it is CFTC that is requiring the FCMs to have their financial statements audited by independent public accountants, it is CFTC's responsibility to see that the independent public accountants have adequate criteria and/or guidelines for conducting such audits. We believe that CFTC needs to work with AICPA to assure itself that the guidelines are issued promptly and meet CFTC's needs and satisfy its requirements.

CFTC ACTION NEEDED TO STRENGTHEN EXCHANGES' AUDIT AND FINANCIAL SURVEILLANCE PROGRAMS

Although CFTC has overall responsibility for protecting the marketplace and customer funds, exchanges, as self-regulatory organizations, are required to enforce their own rules, bylaws, and regulations. As part of this responsibility, they are required to examine the books and records of their members. (A discussion of how well the exchanges carry out their other self-regulatory responsibilities is in ch. 7.) To improve and strengthen exchanges' audit and financial surveillance programs and to assure itself that the exchanges meet their self-regulatory responsibilities, CFTC needs to:

--Provide exchanges with additional specific guidance on how to conduct audit and financial surveillance programs.

--Perform more timely reviews of exchange audit and financial surveillance programs to lessen the need for CFTC audits of member FCMs.

--Be more forceful in getting exchanges to make necessary changes in their programs.

--Coordinate reviews of audit and financial surveillance programs with exchange rule enforcement reviews.

CFTC has delegated to exchanges the responsibility for performing financial surveillance over member FCMs. CFTC oversees and evaluates exchange performance of this responsibility through periodic reviews of exchange audit and financial surveillance programs. To date, CFTC has completed compliance reviews of 9 of the 11 operating commodity exchanges. Reviews of the other two exchanges are currently in process. CFTC's reports for three of the nine reviews completed indicated that the audit and financial surveillance programs were so inadequate that the exchanges were in possible violation of sections 1.51 and 1.52 of CFTC's regulations. CFTC recommended that the three exchanges take specific steps to bring their programs into compliance with the regulations.

Followup reviews were conducted at these three exchanges to make sure that they had taken the necessary corrective actions. The reports on two of these reviews indicate that the actions taken by one of the exchanges brought it into compliance with CFTC's regulations. The report on the second exchange noted that although significant improvements have been made in the exchange's program, deficiencies previously cited continue to exist. According to CFTC's Chief Accountant, the draft report on the third followup review indicates that the actions taken by this exchange have brought it into compliance with CFTC's regulations.

CFTC guidance would improve exchanges' audit and financial surveillance programs

CFTC's reviews of exchange audit and financial surveillance programs indicate that several exchanges had similar deficiencies in their programs. To improve the programs at the nine exchanges already reviewed and to help develop adequate audit and financial surveillance programs at the two exchanges being reviewed, CFTC needs to issue more specific guidance on how to develop an acceptable audit and financial surveillance program. Once the exchanges have fully implemented adequate audit and financial surveillance programs, CFTC will be able to assume an oversight role and reduce its direct audit role over member FCMs.

Since CFTC regulations do not explain what constitutes an acceptable audit and financial surveillance program, CFTC's Division of Trading and Markets issued a Financial and Segregation Interpretation on May 17, 1979, [1] as guidance to the exchanges in developing their surveillance programs. Discussions were also held with the exchanges to assist them in developing their audit and financial surveillance programs. This interpretation states that an exchange's program should include

--monitoring closely an FCM member that is experiencing financial difficulties;

--reviewing thoroughly each financial statement submitted by an FCM member;

--performing onsite examinations of an FCM member's books and records;

--instituting early warning systems to detect FCM members having financial difficulties;

--taking necessary actions to avert financial loss to customers and other contract market members; and

--establishing procedures to be followed when the exchange discovers one of its members has violated its rules, another self-regulatory organization's rules, or CFTC's rules.

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[1] "Advisory Interpretation for Self-Regulatory Organization Enforcement of its Minimum Financial and Related Requirements for Futures Commission Merchants."

The interpretation states that onsite examinations should consist of either a margin audit, debit/deficit audit, limited scope financial compliance audit, complete financial compliance audit, or a combination of these. Although the interpretation does state that a complete financial compliance audit should be done at least once every other year, it does not state how often the other types of audits should be performed.

Considering the number of deficiencies noted in CFTC's initial reviews of the exchanges' programs, we do not believe this guidance was adequate. Our review of the deficiencies CFTC noted in the exchanges' programs showed that the same deficiencies were noted at several exchanges. As shown in the table on the following page, the same six deficiencies were reported in the written programs for at least five of the nine exchanges reviewed.

Deficiencies in written programs (note a)	Number of exchanges with deficiency
Failure to search for and prevent conflicts of interest	8
Failure to provide notice to CFTC of rule violations	7
Failure to develop a comprehensive written program	6
Margin and other limited scope audits not performed on a regular basis	5
Failure to conduct audits on a surprise basis	5
Failure to provide notice of members no longer in good standing (note a not applicable)	5
Failure to analyze pay and collect data on a daily basis	4
No mechanism to monitor volatile price movements	4
Amended financial statements not required (note a not applicable)	1
Incomplete program for review of financial statements (note a not applicable)	1
Failure to adequately monitor FCM's financial condition	1
Inadequate audit staff	1
Deficiencies in implementation of programs (note a)	
Insufficient frequency and/or scope of audits	5
Inaccurate and/or incomplete audit reports and/or workpapers	4
Financial statements not promptly reviewed and acted upon	3
Minimum financial rule not properly applied	2
Prompt enforcement action not taken on rule violations	2
Incomplete record of actions taken	2
Incomplete minutes of business conduct committee--possible conflicts of interest (note a not applicable)	2
Audit reports not issued in a timely manner (note a not applicable)	1
Financial audits did not cover noncommodity accounts (note a not applicable)	1
Capital computation and segregation records not reviewed (note a not applicable)	1
Failure to notify FCMs of increased capital requirements (note a not applicable)	1
Pay and collect data not reviewed	1

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a/Except as otherwise noted, each of these deficiencies was reported by at least one of the exchanges that was found in violation of CFTC's regulations.

The most frequent deficiency in implementing the written programs was insufficient frequency and/or scope of onsite audits. This deficiency was noted in five of the nine exchanges CFTC reviewed.

CFTC's report on the review of the Chicago Board of Trade's financial surveillance program provides an illustration of the need for more specific guidance. The report stated in part that CFTC's Financial and Segregation Interpretation provides that complete financial audits should be conducted at least once every other year and that they should be supplemented by margin audits, debit/deficit audits, and other limited scope financial audits. Although the interpretation does not spell out how often these other audits should be performed, the CFTC report stated that these other types of audits should be done at least once each year and should include sufficient verification of financial data to identify FCMs with financial problems. In commenting on this same deficiency at other exchanges, CFTC did not indicate that margin, debit/deficit, and other limited scope financial audits should be done at least once each year, nor does CFTC's Financial and Segregation Interpretation provide any indication of how often these other types of audits should be performed.

More timely reviews of exchange audit and financial surveillance programs would lessen the need for CFTC audits of member FCMs

CFTC's initial reviews of the exchanges' audit and financial surveillance programs noted deficiencies in all nine programs reviewed. All nine of the exchanges reviewed had deficiencies in their written programs and eight exchanges had deficiencies in implementing their programs. These deficiencies included insufficient frequency of audits, inadequate scope of audits, inadequate and/or incomplete audit reports, and failure to take prompt enforcement action on rule violations.

We believe that these types of deficiencies signify that the exchanges' programs are inadequate for the exchanges to fulfill their self-regulatory responsibilities for providing surveillance over member FCMs. To determine that the exchanges make necessary changes in both their written programs and in the implementation of those programs to make them acceptable to CFTC and to satisfy itself that the exchanges continue to meet their self-regulatory responsibilities, CFTC needs to do more frequent reviews of exchange audit and financial surveillance programs. If CFTC can satisfy itself that the exchanges are fulfilling their self-regulatory responsibilities for auditing and providing financial surveillance over member FCMs, CFTC can then assume an oversight role and reduce the number of audits it performs of member FCMs.

CFTC Regulation 1.52(a) requires each exchange to adopt and submit for CFTC approval, rules prescribing minimum financial and related reporting requirements for all its members who are registered as FCMs. Regulation 1.52(b), which became effective June 30, 1979, requires each exchange to put into effect and to enforce the rules submitted pursuant to Regulation 1.52(a). A program of financial surveillance and enforcement that is vigorously carried out by exchanges should relieve CFTC of routine direct audit responsibility for member FCMs and allow for closer surveillance of FCMs in or approaching financial difficulty. It would also make possible more effective surveillance of those FCMs and other entities that are not exchange members.

CFTC started performing reviews of exchange surveillance activities shortly after the new regulations became effective. The reports covering the first two reviews were issued in February 1980. Six other reviews were completed between June and September 1980. A ninth review was completed in February 1981. Reviews at the remaining two exchanges are in process as of May 1982. About 5 staff years were spent in fiscal years 1980 and 1981 performing reviews of exchange audit and financial surveillance programs.

The CFTC reviews generally covered the exchanges' surveillance work during the last half of 1979 and the first half of 1980. Subsequent reviews have not been conducted, except for limited followup reviews conducted at the three exchanges that were found to be in possible violation of CFTC's regulations and at one other exchange. CFTC issued reports on two of these followup reviews in May 1982. CFTC's Chief Accountant informed us that a followup review has been started at one other exchange. He also stated that no decision has been made as to how frequently CFTC would review exchange audit and financial surveillance programs.

The number and frequency of onsite examinations is an important aspect of an exchange's audit and financial surveillance program and a significant factor in determining whether or not an exchange program meets the self-regulatory requirements of CFTC's regulations. Although CFTC noted that five of the exchanges were not performing a sufficient number of onsite examinations of their member FCMs, CFTC conducted followup reviews at only two of these exchanges to determine whether the exchange had increased its onsite examinations of member FCMs as recommended in the agency's reports.

Just as FCMs must be reviewed periodically to ensure compliance with minimum financial and other CFTC requirements, so must the exchanges be reviewed to ensure their compliance with self-regulatory requirements. The sooner the exchanges have acceptable audit and financial surveillance programs, the sooner CFTC will be able to reduce its direct audit role over member FCMs and move into an oversight role. We believe CFTC's reviews of the exchanges' programs should be performed on a frequent enough basis to ensure continued compliance with the self-regulatory requirements of the act and CFTC regulations. Since all nine exchanges reviewed had deficiencies in their written surveillance programs and eight of the nine had deficiencies in the execution of those programs, we believe that more frequent reviews are needed until such time as CFTC determines that the exchanges have fully acceptable surveillance programs.

CFTC needs to be more forceful in getting exchanges to correct deficiencies in their financial surveillance programs

As noted above, all nine exchanges reviewed by CFTC had deficiencies in their written programs and eight exchanges had deficiencies in implementing their programs. Although most exchanges took corrective action, in some cases an exchange stated that it would not correct the deficiencies CFTC noted because it disagreed with CFTC's position, had difficulty with implementing CFTC's suggestion, or questioned the validity of CFTC's findings. Because CFTC believes that only certain deficiencies in an exchange's surveillance program would result in an exchange being in noncompliance with CFTC regulations, CFTC has not taken appropriate action to get the exchanges to correct the noted deficiencies. We believe that CFTC needs to be more forceful in getting the exchanges to correct deficiencies in their audit and financial surveillance programs.

After reviewing an exchange's financial surveillance program, CFTC staff prepare a comprehensive report that sets forth (1) the exchange's written program, (2) the staff's evaluation of the written program, and (3) the staff's evaluation of how well the exchange has executed the written program. The report is forwarded to the Commission, which must authorize its release to the public and its transmittal to the exchange. When the report is transmitted to the exchange, the exchange is directed to respond in writing to the criticisms in the report. The exchanges are usually given 60 days to respond and indicate what corrective action has been or will be taken on the deficiencies noted.

Exchanges usually reply to CFTC that the corrective action recommended has already been taken or will be taken at some future time. However, in some instances, an exchange has not agreed with the change(s) CFTC recommended and has not modified its program as suggested. Although CFTC could conceivably bring an enforcement action against the exchange, it has been reluctant to do so. Apparently, CFTC believes enforcement action would not be justified by the nature and magnitude of the deficiency. For example, CFTC noted that the New York Cotton Exchange's program did not require that the exchange notify CFTC of CFTC rule violations when they were discovered during the exchange's audits of FCMs. Although CFTC noted that the exchange's program was quite good and that CFTC knew of no instances in which the exchange failed to notify CFTC of financial or segregation violations it had discovered, CFTC reported this as a deficiency in the exchange's program in its September 1980 report. The exchange told CFTC in September 1980 (based on its review of a draft of CFTC's report) that it has consistently advised CFTC that it had difficulty with CFTC's proposition, chiefly because the reporting requirements contemplated by CFTC's suggestion were so open-ended. The exchange said that if CFTC were to adopt a rule which required such notification, the exchange would comply. The exchange suggested that CFTC implement a rule that would clearly and succinctly define when, where, and what type of information should be reported. The exchange concluded by saying that it was willing to meet with CFTC to work out an amicable understanding regarding this issue. An exchange official told us in August 1981 that it has not heard from CFTC on this matter since CFTC issued its report to the exchange.

This same deficiency was reported at six other exchanges. Four of the exchanges agreed to implement CFTC's suggestion and the other two said that they would not incorporate CFTC's suggestion into their written programs. One of the two said that it did provide notification to the Commission when required by law, but would not change its program as suggested in CFTC's report.

A CFTC official informed us that the deficiency noted above is not the type of deficiency CFTC believes is significant enough to justify finding an exchange in noncompliance with CFTC's regulations. If CFTC finds in its review of an exchange's financial surveillance program that the exchange is not complying with CFTC or exchange rules in carrying out its self-regulatory responsibilities, CFTC needs to get the exchange to make the changes necessary to correct any deficiency noted.

CFTC's reviews of exchange financial surveillance programs need to be coordinated with its rule enforcement reviews

Exchange audit and financial surveillance programs are covered under the same CFTC regulation that requires the exchanges to enforce their own rules (Regulation 1.51). To monitor how well the exchanges carry out these responsibilities, CFTC conducts periodic reviews called rule enforcement reviews. (See ch. 7.) To ascertain how well an exchange has carried out its self-regulatory responsibilities during a given period of time, CFTC needs to conduct its reviews of exchange rule enforcement and of exchange audit and financial surveillance programs at the same time. By better coordinating these reviews, CFTC could identify overall deficiencies that may be serious enough when viewed collectively to warrant taking enforcement or other action. As noted above, CFTC has not been aggressive in requiring the exchanges to make changes in their audit and financial surveillance programs and has not taken enforcement action against exchanges for failure to take necessary corrective actions.

CONCLUSIONS

CFTC has continued to audit a substantial number of member FCMs even though the exchanges were delegated the responsibility for auditing FCMs in 1979. More than half of the CFTC audits performed in fiscal years 1980 and 1981 were of member FCMs. We believe CFTC needs to rely more on the exchanges to audit member FCMs and audit member FCMs only to the extent necessary to ascertain that the exchanges are properly fulfilling their responsibilities as self-regulatory organizations.

If CFTC performed fewer of these audits, additional resources would be available for performing other types of financial surveillance, including audits of nonmember FCMs and CPOs, plus increased oversight of the audit and financial surveillance programs of exchanges themselves.

Additional audit capability will be available to CFTC once NFA begins operating. However, to make the best use of this resource, CFTC needs to develop a plan that identifies the specific audit functions that can and will be transferred to NFA and the appropriate timing and sequence of their transfer. The development of such a plan would help NFA establish its audit staff capability and would enable CFTC to more effectively prepare for its oversight of NFA self-regulatory activities.

To help independent public accountants perform required audits of FCMs, audit guidelines need to be prepared. AICPA has been working by itself since 1979 to develop such guidelines, with little assistance from or participation by CFTC. CFTC should work with AICPA to get these guidelines issued promptly and to make sure that they satisfy the agency's needs.

Many of the exchanges had similar problems in their audit and financial surveillance programs. To improve the financial surveillance programs at the nine exchanges that have been reviewed and at the two exchanges that are being reviewed, CFTC should provide additional specific guidance to the exchanges on how to develop an acceptable audit and financial surveillance program.

CFTC has completed reviews of the financial surveillance programs of 9 of the 11 commodity exchanges. All nine exchanges had deficiencies either in their written programs or in the implementation of these programs. Limited followup reviews were performed at the three exchanges where the programs were determined to be so inadequate that the exchanges were in possible violation of CFTC regulations and at one other exchange. CFTC's followup needs to be more systematic.

Although CFTC has turned over the responsibility for auditing and monitoring of member FCMs to the various exchanges, CFTC is ultimately responsible for determining that customer funds are adequately protected. In this respect, CFTC must satisfy itself that the audit and financial surveillance programs of the exchanges are properly developed and implemented. If CFTC finds during its review that an exchange's financial surveillance program is not in compliance with CFTC or exchange rules, CFTC needs to take appropriate action to get the exchange to make the changes necessary to correct any deficiencies noted.

By coordinating its financial surveillance and rule enforcement reviews, CFTC would be in a better position to determine if an exchange is meeting its self-regulatory responsibilities under CFTC Regulations 1.51 and 1.52.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To enhance the overall audit and financial surveillance program for safeguarding customer funds, the Commission should:

--Reduce the number of audits of member FCMs and rely instead upon the exchanges to be the primary monitors of these FCMs.

--Devote additional audit resources to monitoring nonmember FCMs and CPOs.

--Develop a plan for transferring specific audit functions to NFA.

--Work with AICPA to provide for the timely publication of audit guidelines for use by independent public accountants in performing audits of FCMs.

--Provide additional specific guidance on how to conduct exchange audit and financial surveillance programs.

--Perform more frequent reviews of the exchanges' audit and financial surveillance programs and perform more active followup so that exchanges modify their audit and financial surveillance programs to comply with CFTC's recommendations.

--Conduct reviews of exchange audit and financial surveillance programs in conjunction with rule enforcement reviews.

AGENCY COMMENTS AND OUR EVALUATION

CFTC's comments indicate general disagreement with our conclusions and recommendations. In a few cases, CFTC is implementing our recommendations. For example, CFTC has reduced its audits of member FCMs and has increased its audits of nonmember FCMs and CPOs. Based on CFTC's comments, we have made changes to (1) reflect the actions taken by CFTC and (2) further reflect CFTC's position on the matters discussed in our draft report.

CFTC's comments addressed each of the recommendations in this chapter except the recommendation that the Commission should conduct reviews of exchange audit and financial surveillance programs in conjunction with rule enforcement reviews. CFTC's comments are presented in their entirety in appendix XV.

CFTC stated that it does not believe that excessive resources have been devoted to auditing member FCMs. CFTC stated that experience has shown that periodic visits to member FCMs significantly improve the levels of compliance with CFTC's segregation and recordkeeping regulations. CFTC also stated that the procedures its staff has used over the past several years when auditing member FCMs have been considerably streamlined so that these audits take much less time. According to CFTC, this is the primary reason why it has been able to conduct more audits of nonmembers and CPOs without conducting significantly fewer audits of members. CFTC considers this an efficiency, not a deficiency.

CFTC also stated that simply comparing the total number of member audits (150) with the total number of nonmember audits (150) is not an accurate measure of the level of audit coverage. First, because of the streamlined procedures used in member audits, the amount of staff hours spent on nonmember audits was significantly greater than the amount expended on member audits. Second, CFTC stated that it is important to recognize that there are more than three times as many members as nonmembers. In conclusion, CFTC stated that its audit staff will not be able to audit member FCMs as frequently in the future because of the additional resources being devoted to auditing CPOs. CFTC also stated that during the first 4 months of fiscal year 1982, it had increased its audits of nonmember FCMs. During this period, CFTC conducted 76 FCM audits of which 55 (72 percent) were of nonmember FCMs.

We agree with CFTC's statement that periodic visits to member FCMs significantly improve the levels of compliance with CFTC segregation and recordkeeping regulations. We recognize that compliance with these regulations is necessary. Our point is not that visits should be reduced, but only that more of them should be done by the exchanges rather than CFTC. Exchange enforcement of those rules can and should be attained through periodic audits performed by the exchanges and not by CFTC. As our report points out, the purpose of making the exchanges responsible for auditing member FCMs was to enhance industry self-regulation and to relieve CFTC of routine direct audit responsibility.

The first section of this chapter addresses the need to place more reliance on the exchanges to audit their own members. However, CFTC's comments did not address this issue. As our report points out, exchange enforcement of its rules and those of CFTC is the key to the self-regulation process that the Congress envisioned when it established CFTC. If CFTC were to reduce its audits of member FCMs and rely more on the exchanges to audit their members, CFTC could then assume an oversight role and shift its resources to the monitoring of nonmember FCMs, exchanges, or other participants in the commodities industry.

CFTC commented that it recognizes the importance of frequently auditing and monitoring nonmember FCMs and that substantive new audit and surveillance techniques have been introduced. For example, CFTC requires nonmember FCMs holding customer funds to report their segregation calculations daily with written reports filed weekly. In addition, to the extent possible, CFTC performs monthly limited scope audits of each nonmember FCM holding over $1 million of customer funds.

CFTC stated that it does not believe that its audit coverage of nonmembers has been inadequate. CFTC also disagreed with our position that it is necessary to audit each nonmember FCM at least once every 2 years even if the FCM does not hold customer funds. CFTC stated that the protection of customer funds is by far the most important reason for conducting financial audits of FCMs. Therefore, FCMs without customer funds are always assigned the lowest audit priority. CFTC also stated that these FCMs are audited annually by independent public accountants and that their quarterly financial statements are thoroughly reviewed by CFTC auditors.

Our report has been revised to reflect that CFTC has instituted new audit and surveillance techniques. We agree that CFTC should place its primary emphasis on auditing FCMs that hold customer funds. However, we believe that CFTC also has a responsibility to ascertain if nonmember FCMs are complying with all of CFTC's financial and recordkeeping requirements and not just those that deal with the protection of customer funds. To remain registered, FCMS are required to comply with these requirements at all times. CFTC's comments only emphasized the need to protect customer funds and did not address the need for FCMs to comply with CFTC's other financial and recordkeeping requirements. We continue to believe that CFTC should provide some type of audit coverage of nonmember FCMs on a recurring basis. As CFTC commented on its auditing of member FCMs, "Experience has shown that periodic visits to member FCMs significantly improve the levels of compliance with" CFTC's regulations.

While an FCM may not hold customer funds as of a certain date, this does not mean that it has not held customer funds on other dates or that it has not had recordkeeping problems. We have noted that 17 nonmember FCMs without customer funds as of

September 30, 1981, were audited by CFTC in the past 2 years and that 12 of the 17 received compliance and/or warning letters from CFTC or an enforcement action. Our report has been revised to reflect the nature of CFTC's findings for these audits. A review of the files for some of these firms indicated that they had been cited for violating various portions of CFTC's financial and recordkeeping requirements. Although these FCMs did not hold customer funds as of September 30, 1981, the files indicate that some of these FCMs had held customer funds in the past. Some had also been cited by CFTC for being undersegregated.

Our draft report proposed that CFTC perform more audits of CPOs. CFTC stated that it recognizes the need for performing more audits of CPOs and that it has increased its audits of CPOs in the first 4 months of fiscal year 1982. CFTC also stated that the staff hours devoted to CPO financial audits is about twice the level of fiscal year 1981. Our report has been revised to reflect the actions taken by CFTC in response to our draft report.

Although CFTC's comments indicated disagreement with our conclusion that CFTC was devoting substantial audit resources to audits of member FCMs, thereby reducing the resources available for audits of nonmember FCMs and CPOs, CFTC has taken steps to implement our recommendations. CFTC stated that approximately 70 percent of the FCM audits conducted during the first 4 months of fiscal year 1982 have been of nonmembers. CFTC also stated that it would not be able to audit member FCMs as frequently in the future because of the additional resources being devoted to auditing CPOs. During the first 4 months of fiscal year 1982, CFTC completed 37 financial audits of CPOs. At that rate, 111 financial audits of CPOs will be completed during the fiscal year, or more than a 50-percent increase over the prior fiscal year.

CFTC stated that it does not believe that development of a formal plan for the transfer of specific audit functions to NFA would be an appropriate use of its limited resources at this time. CFTC also stated that until such time as NFA engages an audit staff, efforts to develop a plan would be of little benefit and not worth the resource commitment.

We do not agree with CFTC's comment that the development of a formal plan for the transfer of specific audit functions to NFA would be an inappropriate use of its resources. CFTC's comments indicated more concern about when a plan should be developed than about the actual need for such a plan. However, we pointed out that a plan would not only help NFA establish its audit staff capability but would also enable CFTC to effectively prepare for its oversight of NFA. Also, if CFTC and NFA were to work on a plan for the transfer of specific audit functions, CFTC would then be in a better position to determine how to best use its limited resources.

CFTC stated that it continues to believe that detailed audit guidelines for conducting FCM audits should be developed by the accounting industry. CFTC also stated that it will work with the AICPA subcommittee to develop and issue the guidelines as soon as practicable and that it will ensure that such guidelines meet its needs and satisfy its requirements.

The chairman of the AICPA subcommittee developing the guidelines also believes that detailed audit guidelines for conducting FCM audits should be developed by the accounting industry. However, the accounting industry has been working on these guidelines since 1979 and will not have a draft of these audit guidelines for CFTC's review and comment until late 1982.

We first recommended the development of such guidelines in 1975 and again in 1978. In 1979 CFTC officials told us that they were "putting a lot of pressure on AICPA to finish these guidelines." However, over 2 years later, the guidelines still are not available. CFTC has stated that it will work with the AICPA subcommittee "in order to develop and issue guidelines as soon as practicable." However, CFTC's statement does not indicate any commitment on its part to get these guidelines issued in a timely manner. CFTC's involvement has consisted of a few general discussions with subcommittee members, and CFTC will also be asked to review the draft guidelines once AICPA develops them. We continue to believe that CFTC needs to work with the AICPA subcommittee to issue these long-delayed guidelines as soon as possible and to make sure that they meet CFTC's needs and satisfy its requirements.

CFTC stated that its financial and segregation interpretation for the development of exchange audit and financial surveillance programs provides adequate guidance to the exchanges and accordingly does not need to be amended. CFTC stated that the interpretation was intentionally structured to provide guidance to exchanges rather than to dictate that each exchange adopt identical procedures and program elements. CFTC also stated that while it was important that all exchange programs meet certain basic requirements, each exchange should be encouraged to develop programs to fit its special circumstances.

Our review revealed that the deficiencies noted by CFTC during its reviews of the exchanges' audit and financial surveillance programs were similar in many cases. For example, CFTC noted that the written programs of at least five of the nine exchanges reviewed lacked the same six procedures. CFTC recommended that the exchanges include these procedures in their written programs. Considering the number and similarity of the deficiencies noted by CFTC in its initial reviews of the exchanges' programs, we do not believe that the guidance provided to the exchanges was adequate. More specific guidance would have precluded CFTC from having to make as many recommendations to the exchanges to include specific procedures in their audit and financial surveillance programs. Although CFTC has stated that it does not want to dictate to the exchanges what specific procedures the exchanges should include in their audit and financial surveillance programs, our review of CFTC's reports indicates that CFTC was fairly specific about the types of procedures each exchange should include in its audit and financial surveillance program.

We agree with CFTC that the manner in which the exchanges meet these basic requirements should be left to the discretion of the exchanges. In our opinion, the basic requirements CFTC refers to can be construed as the procedures CFTC noted were lacking in the exchanges' programs. Also, the exchanges are free to include any procedures they feel necessary to fit their own special requirements.

CFTC agreed that reviews of exchange programs should be performed frequently enough to ensure continued compliance with the self-regulatory requirements of the act and CFTC regulations. However, CFTC did not agree with our conclusion that such reviews to date have been insufficient. CFTC commented that its staff has frequent contact with exchange audit staffs during which problems and concerns about an exchange's program are discussed and rectified. CFTC believes that this day-to-day oversight is equally if not more important than periodic formal program reviews.

We agree that frequent contact with exchange audit staffs is a sound approach for resolving day-to-day problems that arise concerning an exchange's audit and financial surveillance program. However, we do not believe that day-to-day surveillance is more important than formal periodic reviews that result in reports to the Commission and to the exchanges. These reports provide a formal notification to the exchanges of what CFTC expects of the exchanges in fulfilling their self-regulatory responsibilities for audits and financial surveillance. With day-to-day oversight, there is no formal record of what was discussed and agreed upon. A report to the exchange and the exchange's response serves as a record of what CFTC has found wrong with the exchange's program and what the exchange has done, or plans to do, to correct any deficiencies in its program. We continue to believe that CFTC needs to perform more timely reviews of the exchanges' audit and financial surveillance programs to satisfy itself that the exchanges continue to meet their self-regulatory responsibilities. These formal reviews also evaluate the entire exchange program at one time rather than dealing with individual segments on a daily basis.

CFTC does not agree with our conclusion that it has not been forceful enough in requiring exchanges to adopt recommendations made as a result of audit and financial surveillance reviews. CFTC pointed out that the majority of its recommendations had been adopted by the exchanges. CFTC also stated that it should be noted that the New York Cotton Exchange's overall program was quite good and CFTC knew of no instance in which the exchange failed to notify CFTC of financial or segregation violations it discovered. Our report has been revised to reflect CFTC's comments on the New York Cotton Exchange's program.

It should be noted that six other exchanges had the same deficiency as the New York Cotton Exchange, the exchange which we cited as an example in our draft report. Four of the six exchanges agreed to implement the recommended change; one exchange stated that it would continue to provide notification to CFTC when required to do so by law but would not incorporate CFTC's suggestion into its written program; and the sixth exchange stated that it would not implement the recommended change. This last exchange stated that it disagreed with CFTC's position because the exchange (1) is not legally required to abide by CFTC's financial and segregation interpretation, which states that this procedure should be included in an exchange's program, (2) is only obligated to enforce CFTC rules to the extent that they are substantially similar to the exchange's rules, and (3) would be impeded in its ability to monitor its firms if it were required to report all violations of CFTC rules. The exchange did state, however, that it would inform CFTC of repeated violations and/or material violations of CFTC rules.

EXCHANGE COMMENTS AND OUR EVALUATION

The New York Cotton Exchange provided comments on the portion of our draft report where we cited it as an example of how CFTC has not always been forceful in getting the exchanges to modify their programs as suggested by CFTC. 1/ The New York Cotton Exchange stated that although our chronology was correct regarding the exchange's position, it thought that the tone and purpose of its discussions with CFTC was missing. The exchange quoted extensively from two letters it had sent to CFTC on this matter. These letters conveyed the exchange's willingness to meet and work with CFTC to reach an amicable understanding regarding this portion of its audit program.

The exchange pointed out that it would be willing to adopt a procedure for giving CFTC notification of possible rule violations if CFTC were to amend its regulations to require the exchanges to give such notification. The exchange felt that if CFTC adopted such a rule, it would enable the exchanges to specifically know when, where, and what potential rule violations would be subject to reporting.

1/ The exchange's comments are presented in their entirety in app. XVI.

We have revised our report to reflect the New York Cotton Exchange's comments. We have also revised the report to note that six other exchanges had the same deficiency we cited in our report for the New York Cotton Exchange. The report also reflects what action these other exchanges took on the deficiency CFTC noted.

OTHER COMMENTS AND OUR EVALUATION

The Department of Justice provided detailed comments on our draft report's discussion of NFA. See page 74 for response to those comments.

CHAPTER 7

NEED FOR CONTINUED IMPROVEMENT IN CFTC's RULE ENFORCEMENT REVIEW PROGRAM AND EXCHANGE SELF-REGULATION

Commodity futures exchanges have traditionally imposed rules on their trading and membership to minimize abuses that would threaten the viability of trading and undermine public confidence in their markets. In 1968 the Congress enacted legislation to strengthen exchange self-regulation by requiring exchanges to enforce their own rules. In 1974, when the Congress created CFTC, it authorized CFTC to approve and disapprove exchange rules and created an oversight and enforcement role for CFTC that was considerably stronger than that of its predecessor, the Commodity Exchange Authority.

Central to CFTC's role in overseeing exchange self-regulation is its rule enforcement review program. Under this program, CFTC officials have, since 1975, made onsite investigations and prepared reports evaluating exchange performance of those self-regulatory obligations that the exchanges are required by law to carry out. Rule enforcement reviews are among CFTC's most critical functions because they indicate how well exchanges are regulating themselves and whether exchanges are ready to take on additional self-regulatory responsibilities--an increasingly important goal in times of limited Federal budgets. How well CFTC conducts these reviews is also an important measure of CFTC's capacity to oversee exchange activities and preserve public confidence in futures trading.

In 1978 we reviewed CFTC's rule enforcement review program and recommended numerous improvements. In 1981 we assessed CFTC's progress in improving rule enforcement reviews. Although we found that some improvements had been made in the interim, we found a need for continued improvements, particularly in the planning and scheduling of rule enforcement reviews, in the scope and coverage of these reviews, and in the criteria used to assess exchange self-regulatory performance. We found a need also, at least in the short run, for the Commission to provide increased support for the rule enforcement review program to enable it to meet its objectives of evaluating the effectiveness of exchange self-regulation and upgrading self-regulation to the point where it can fulfill the role envisioned by the Congress in its overall statutory scheme for commodity futures regulation.

EXCHANGE SELF-REGULATORY RESPONSIBILITIES AND CFTC REGULATORY OVERSIGHT

Sections 5, 5a, and 6 of the act list certain conditions and requirements that must be met for an exchange to be initially designated as a contract market and for it to maintain its designation. Section 5a(8) provides that an exchange must:

> "* * * enforce all bylaws, rules, regulations and resolutions, made or issued by the governing board thereof or any committee, which relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market or relate to other trading requirements, and which have been approved by the Commission * * * and revoke and not enforce any such bylaw, rule, regulation, or resolution, made, issued, or proposed by it or by the governing board thereof or any committee, which has been disapproved by the Commission". 1/

The statutory requirement that exchanges enforce their own rules is amplified in Regulation 1.51. This regulation provides that each exchange must exercise "due diligence" in enforcing its own bylaws, rules, regulations, and resolutions and that it must maintain a continuing affirmative action program to ensure compliance with various provisions of the act. Regulation 1.51 sets forth eight elements or subprograms that each exchange's affirmative rule enforcement program must include. These are

- --overseeing market activity to detect and prevent situations conducive to price distortion;
- --overseeing floor trading practices to detect and prevent trading abuses;
- --examining members' books and records;
- --investigating customer complaints;
- --investigating alleged or apparent rule violations;
- --conducting other record examinations, surveillance, and investigations needed to enforce exchange rules;
- --developing procedures for taking prompt and effective disciplinary action against rule violators; and
- --keeping full, complete, and systematic records.

CFTC's Guideline II provides some additional information on the components of an adequate exchange rule enforcement program and discusses the objectives of the eight subprograms listed above. We recommended in 1978 that this 1975 guideline be revised to provide more specific guidance and standards for

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1/Before the 1974 amendments, the Commodity Exchange Authority acted on exchange rules only to the extent of disapproving rules that violated the act. Acceptable rules did not receive formal Federal approval.

exchange self-regulatory activities. To date, however, this has not been done.

The Trading and Markets Division administers CFTC's rule enforcement review program to assess exchange compliance with requirements of the act, Regulation 1.51, and Guideline II. CFTC has stated that these rule enforcement reviews, also known as compliance reviews, are one of the principal tools for bringing about effective self-regulation in the futures industry since they enable CFTC to determine whether an exchange is enforcing its own rules and carrying out its self-regulatory responsibilities. If an exchange is not meeting its responsibilities, the rule enforcement review process can provide the basis for determining whether CFTC enforcement action against the exchange is appropriate. Enforcement action could include suspending or revoking contract market designation, issuing cease and desist orders, and imposing civil penalties of up to $100,000 for each violation. The rule enforcement review process can also provide a basis for the Commission to determine whether a proposed contract submitted to CFTC for its approval would be contrary to the public interest and therefore should not be approved.

Rule enforcement reviews can also provide the means for improving the effectiveness of futures market regulation to permit the reassigning of those functions that the private sector can perform, thus streamlining the Federal role to include only those functions necessary to assure that the broad public policy objectives of the act are met. However, until a sufficient level of compliance with self-regulatory requirements can be demonstrated, significant further movement toward a CFTC oversight role would be premature and probably contrary to the public interest. Moreover, because of the governing incentives of exchange members and the inherent potential for conflicts of interest in exchange self-regulation, 1/ it is unrealistic to assume that the Federal Government will be able to withdraw completely from this area.

1/The limitations of self-regulation are traceable to the very nature of commodity exchanges as voluntary organizations composed of members whose primary motivation is--understandably--profitmaking. The exchange member's profit motive and his or her role as an enforcer of rules against himself or herself and other members (e.g., as an exchange board member or member of an exchange governing or disciplinary committee) can and do give rise to actual or potential conflicts of interest.

OVERVIEW OF RULE ENFORCEMENT REVIEW PROGRAM: PROGRESS IN SOME AREAS, ADDITIONAL IMPROVEMENTS NEEDED

Our examination of CFTC's rule enforcement review program and of the reports on exchange self-regulation produced since our 1978 review indicates that while some improvements have been made, a number of weaknesses remain. Since 1978 CFTC has improved its reviews by (1) providing more thorough documentation and support of review findings, (2) adopting internal guidelines for conducting reviews, and (3) stating more clearly whether exchanges are violating provisions of the act and of CFTC regulations. At the same time, however, weaknesses limit the program's ability to assess the quality of exchange self-regulation and to upgrade exchange self-regulation over time. These weaknesses include the largely descriptive nature of rule enforcement reviews; problems related to planning, scoping, and conducting reviews; inefficiencies in the use of staff resources and expertise; slow followup on report recommendations; and insufficient Commission direction, control, and support of the program.

Rule enforcement reviews are largely descriptive

Partly as a result of the methodology used to conduct rule enforcement reviews--in particular, reliance on interviews with exchange officials and employees; review of exchange disciplinary records; and examination of exchange files, reports, minutes, logs, and other documents--rule enforcement review reports are largely descriptive. While the reports describe the formal programs, procedures, manuals, organization, and staffing that exchanges have installed to comply with self-regulatory requirements, they do not, by and large, reflect independent CFTC testing and investigation of these factors.

A March 20, 1979, memorandum to the Commission from the then Director of the Trading and Markets Division acknowledged the essentially descriptive character of rule enforcement reports. In the memorandum the Director addressed criticisms of the program we made in 1978 as well as our recommendations for improving the program. He noted that experience with rule enforcement reviews had provided CFTC with a "baseline description" of the exchanges' organization and their stated operating methods but that the reviews had provided little, if any, examination or investigation of the quality of exchange programs. As illustrations, he observed that while division staff had recorded and reviewed the paperwork of exchange investigations, they had not generally examined the original source documents or checked to see that the investigations were as thorough or as complete as they should be. Also, CFTC did not generally investigate areas that the exchange itself did not investigate or, in most instances, conduct trade practice investigations or other investigations to discover what the exchanges were not finding through their own compliance activities. The Director said that, in line with our recommendations, the program should be modified to include an independent CFTC analysis and interpretation as to the effectiveness of the exchanges' programs.

Some of the improvements the Director proposed in 1979 have been adopted. Exchange rule enforcement reviews are now supplemented to some extent by Trading and Markets Division "referrals" to the exchanges for investigation and followup reporting to CFTC. Referrals of alleged or suspected improprieties are also made occasionally to CFTC's Enforcement Division for its investigation and possible action. During two recent rule enforcement reviews, the Trading and Markets Division also reviewed and analyzed specific exchange market surveillance situations, notably in the case of silver trading in late 1979 and early 1980. Nevertheless, the reviews remain largely descriptive and, as a consequence, of limited value in assessing the effectiveness of exchange rule enforcement programs.

In fairness to CFTC, it must be noted that serious weaknesses in the basic form, organization, and staffing of many exchange compliance programs have obliged the agency to focus on fundamentals first; that is, the form of exchange self-regulation rather than the substance. This focus on getting exchanges to install the basic structure of self-regulation has been reflected in the comments of CFTC staff and Commissioners and is perhaps best summed up by the observations of the Director of Trading and Markets. When we asked him for his assessment of exchange self-regulation and his estimate of how long it would be before self-regulation could be relied upon to effectively regulate futures markets, he replied that the real progress to date has been in getting exchanges to put the basic rule enforcement machinery in place, to develop systems, and to hire professional staff. He said that the exchanges now all have at least a "pretense" of a self-regulatory program, "and it has taken us some time to get to this point." The question now is: Do they have the willingness to use what they have to be effective? The next and more difficult step, he said, will be to get the exchanges to commit themselves to effective self-regulation. This commitment, he added, will be much more difficult for CFTC to measure--that is, to actually evaluate how the self-regulatory systems are running.

Rule enforcement reviews are not comprehensive enough to satisfy CFTC's present information needs

Our 1978 report noted that the Trading and Markets Division staff did not promptly follow up on rule enforcement reviews to ensure that exchanges took necessary actions to correct deficiencies revealed by these reviews. We recommended that CFTC perform such followup and that it take whatever action was needed, including enforcement action, to obtain prompt compliance with its rule enforcement requirements.

Our present review disclosed that Trading and Markets Division staff still do not take sufficient substantive followup action to ensure prompt compliance with rule enforcement report recommendations. Followup currently consists largely of ensuring that an exchange replies to CFTC within a specified time (generally 45-90 days) concerning the action it has taken or intends to take to correct identified deficiencies. Actual verification of corrective action and assessment of its adequacy must often wait until the Trading and Markets Division conducts a subsequent rule enforcement review at the exchange, usually several years later. Moreover, unless the subsequent rule enforcement review includes an examination of the subprogram(s) previously found to be deficient--and this is frequently not the case--CFTC cannot be certain whether an exchange has taken action sufficient to bring its rule enforcement program into compliance with statutory and agency requirements.

Differences in the thoroughness and coverage of rule enforcement reviews from one exchange to another and between consecutive reviews conducted at the same exchange often make it difficult even to compare exchanges regarding the overall quality of their rule enforcement programs or, just as importantly, to assess the progress of a given exchange in improving its compliance program over time. Appendix XIV illustrates the selective and incomplete coverage of Regulation 1.51 subprograms in successive rule enforcement reviews performed at the Nation's commodity exchanges since 1975. The appendix shows that although the Trading and Markets Division examined seven exchange subprograms in its 1977-78 review of the Chicago Board of Trade and found five of these subprograms to be deficient, the division examined only two of the Regulation 1.51 subprograms in its recent Chicago Board of Trade review. As a result, CFTC has no way of knowing, 4 years later, to what extent the Nation's largest exchange has overcome a number of the weaknesses in its rule enforcement program documented in 1978.

A comparison of consecutive rule enforcement reviews at the New York Cotton Exchange provides another example of incomplete coverage. In its second rule enforcement review of this exchange, completed and reported in 1978, CFTC examined six of the exchange's Regulation 1.51 subprograms and found three of them to be deficient. Nevertheless, in its 1979-80 review of the exchange's compliance program, the Trading and Markets Division examined only two of the exchange's Regulation 1.51 subprograms. It did not examine the exchange's market surveillance program, which was found to be seriously deficient in two prior rule enforcement reviews. Other examples of incomplete Regulation 1.51 coverage are provided by rule enforcement reviews of the New York Cocoa Exchange and the New York Mercantile Exchange. (See app. XIV.)

Commission support for its rule enforcement review program has been insufficient

Our review disclosed that despite the importance of rule enforcement reviews, the program has not received the support that, in our view, it merits and requires. Commission support problems relate both to the relatively low and declining proportion of CFTC resources devoted to rule enforcement reviews and to the lack of Commission direction and oversight of the rule enforcement review program.

The rule enforcement review activity represents a small and declining fraction of CFTC's work. In fiscal year 1978 CFTC devoted 7.54 staff years to rule enforcement reviews, or 1.64 percent of CFTC's total staff years. In fiscal year 1980 CFTC devoted 7.44 staff years to rule enforcement reviews, or 1.59 percent of the CFTC staff-year total. By fiscal year 1981 only 5.64 staff years were devoted to this activity, representing 0.97 percent of total CFTC staff years. In the first quarter of fiscal year 1982 rule enforcement reviews used 1.41 staff years, or 0.91 percent of CFTC's total. The Trading and Markets Division resources devoted to rule enforcement reviews decreased from 6.31 percent in fiscal year 1980 to 4.59 percent in fiscal year 1981 and 4.27 percent in the first quarter of fiscal year 1982.

In our view, this relatively low and declining level of resources devoted to rule enforcement reviews is not consistent with the crucial importance of rule enforcement reviews to accomplish statutory purposes. It is also not sufficient to provide CFTC with up-to-date and reliable assessments of particular exchange compliance programs, assessments it needs to streamline its own regulatory role and move further toward regulatory oversight.

The low and declining level of resources devoted to rule enforcement reviews has been accompanied in recent years by a relatively low level of Commission involvement in and attention to the program. Because exchange self-regulation is so important to accomplish the purposes of the act and because CFTC needs to ensure the most effective use of scarce resources, we believe it is important for the Commission to play an active role in directing and monitoring the rule enforcement review activity. This would include providing appropriate guidance to the Trading and Markets Division on the particular factors that it believes ought to be emphasized in planning, scheduling, and scoping rule enforcement reviews. The Commission, however, has in recent years exercised a minimum of direction and oversight of rule enforcement reviews.

In 1978, in response to our recommendations for improvements in the program, the Commission indicated that it had directed its staff to prepare fiscal year schedules of planned rule enforcement reviews in connection with preparing its annual calendar. The Commission further stated that in addition to the annual rule enforcement review plan, it would require the staff to submit plans for each specific rule enforcement review for advance approval. This approval would be required before the Commission would authorize the initiation of the review. According to Commission documents, these procedures were adopted in April 1978 to ensure "greater Commission level awareness of the continuing status and operation of this important program."

By the time we began our current review in mid-1981, the procedures outlined above had been discontinued. The Deputy Director, Trading and Markets Division, told us that the division no longer seeks or obtains the Commission's advance approval to start a rule enforcement review. The reason given for this was that since the division has discontinued taking sworn depositions of exchange employees and officials, requesting a formal order of investigation from the Commission is no longer necessary. The Director added that the first involvement the Commission now has in a rule enforcement review is when it receives the division's final report.

We found that with the decline in direct Commission involvement in the program has come a corresponding decline in the extent and precision of planning for rule enforcement reviews. However, the division had not always been successful in adhering to the plans which had been reviewed and approved by the Commission, as indicated in the following plan for fiscal year 1980.

Exchange	Planned completion date	Actual completion date (or reporting date)
1. MidAmerica Commodity Exchange	3/31/80	Date of report 6/10/80
2. AMEX Commodities Exchange	12/31/79	Date of report 2/6/80
3. New York Cotton Exchange	3/31/80	Presented to Commission 2/20/80
4. Coffee, Sugar, and Cocoa Exchange	3/31/80	Date of report 2/17/81
5. Chicago Mercantile Exchange	6/30/80	Presented to Commission 5/25/82 (begun Nov. 1980)
6. Commodity Exchange, Inc.	9/30/80	Date of report 9/16/81
7. New York Mercantile Exchange	6/30/80	Date of report 5/23/80
8. Chicago Board of Trade	9/30/80	Presented to Commission 4/20/82 (begun Aug. 1980)
9. New York Futures Exchange	1/ 9/30/80	In progress as of 5/15/82 (begun Nov. 1981)

1/The New York Futures Exchange was designated by the Commission as a board of trade on July 15, 1980. Trading did not begin on the exchange until Aug. 7, 1980.

In reviewing an advance copy of CFTC's fiscal year 1981 annual report, we noted that the Commission indicated an intention to perform eight rule enforcement reviews in fiscal year 1982. We requested further details on these planned reviews from Trading and Markets officials. On January 6, 1982, more than one quarter into the new fiscal year, the division's Assistant Director told us that the eight planned reviews are the next eight to be done by the division; that is, the actual selection of exchanges to be reviewed had not yet been completed.

Need for better planning, scoping, and scheduling of rule enforcement reviews

Several factors, in our view, need to be considered in planning, scoping, and scheduling exchange rule enforcement reviews. These include:

--the time that has elapsed since the prior review of an exchange (both in an absolute sense and relative to the time that is allowed to pass between reviews of other exchanges),

--the nature and seriousness of the deficiencies disclosed in the prior review(s),

--the nature and extent of agency followup on previously disclosed deficiencies and what such action reveals concerning corrective action taken,

--the size and economic importance of an exchange (for example, the number and variety of contracts traded, trading volume, and trends in growth), and

--exchange cooperation and attitude (that is, the experience CFTC has had in working with an exchange to improve its self-regulatory performance).

Other relevant factors include the designation of additional contracts for trading on the exchange, the assignment of new regulatory responsibilities to the exchange, any new and significant developments (for example, exchange mergers or serious market distruptions), and CFTC budget and staff resources available to perform rule enforcement reviews. Exchange plans to participate in new trading programs such as CFTC's proposed exchange options program would also be relevant, since such new trading activity could seriously burden and further weaken an already inadequate exchange compliance program.

Clearly, CFTC officials must use subjective judgment in weighing these factors, and the Commission has not provided guidelines to help Trading and Markets Division personnel make these judgments for planning purposes. Nevertheless, the job of planning, scoping, and scheduling rule enforcement review activities is an essential one if these reviews are to be performed efficiently and effectively. It is also one which, if done properly, would produce a balanced rule enforcement review activity in which CFTC scrutinizes each exchange to a degree commensurate with its relative size and importance, the presumed quality of its compliance program, and the need to ensure that all exchange programs are in conformity with statutory and CFTC requirements. A balanced and measured approach has not resulted from the Trading and Markets Division's rule enforcement review effort to date.

As noted, we found that the Trading and Markets Division typically does not perform a prompt, substantive followup to assess whether or not exchanges have acted to correct deficiencies noted in rule enforcement reviews. The subsequent rule enforcement reviews are the first real effort to verify and assess corrective actions taken. As a result, several years may pass before CFTC has a clear idea of whether an exchange has implemented its recommendations for improvements. In the case of the Nation's two largest exchanges--the Chicago Board of Trade and the Chicago Mercantile Exchange--the division waited nearly 4 years to perform followup evaluations. This long delay in reexamining these exchanges is also significant because of their sheer size and economic importance. In 1981 nearly 75 percent of the total volume of commodity futures trading took place on these two exchanges. Moreover, in the case of the Chicago Board of Trade, the division's January 1978 report had disclosed serious weaknesses in the exchange's compliance program. The rule enforcement reviews of these two exchanges represent only the second CFTC examination of these exchanges, while each of the established New York exchanges has been reviewed three times. (See app. XIV.)

We also found, as noted earlier, that rule enforcement reviews are not consistent in their scope and do not always cover all of the eight Regulation 1.51 subprograms, even when these subprograms have previously been found to be seriously deficient. Conversely, the Trading and Markets Division may perform comprehensive reviews of exchange programs previously found to be without serious deficiency. Such reviews are best exemplified, respectively, by the Chicago Board of Trade and Chicago Mercantile Exchange reviews discussed above and on pages 122-24.

Staff resources and expertise not used as effectively as possible

One way to improve the rule enforcement review process is to ensure the most efficient and effective use of staff resources and expertise, not only within the Trading and Markets Division but throughout CFTC. Our review disclosed that although some steps have been taken to improve the efficiency of staff use, such as developing a procedures manual for use by Trading and

Markets Division staff in planning and conducting compliance reviews, 1/ other opportunities for improved staff use exist that have not yet been exploited. These include using CFTC surveillance economists in planning and conducting reviews of exchange market surveillance programs and more effectively using Trading and Markets Division regional staff.

In conducting surveillance of futures markets, CFTC's surveillance economists become knowledgeable in areas that clearly apply to rule enforcement reviews. For example, surveillance economists must become familiar with (1) the terms and conditions of futures contracts they oversee, (2) the underlying cash markets and their relation to the futures markets, (3) key market participants in both cash and futures markets, and (4) the exchanges' market surveillance programs. The surveillance economists' understanding of the process and requirements of market surveillance and their knowledge of exchange surveillance programs enable them to make a valuable contribution to the Trading and Markets Division's evaluation of an exchange surveillance program. This contribution includes information regarding what constitutes an adequate program for a particular commodity, the salient characteristics of the exchange's program, and indications as to where surveillance weaknesses may exist.

At the time of our review, surveillance economists were not significantly involved in rule enforcement reviews. CFTC's Director of Market Surveillance told us that the Trading and Markets Division will occasionally seek his section's views on a particular exchange's program or ask it to review the division's findings; however, this is not done regularly. The Director noted that, as part of CFTC's executive development program, he and the Trading and Markets Division Director are expected to collaborate in developing a program to increase surveillance involvement in rule enforcement reviews. As of January 1982, this had not been accomplished.

With the centralization of CFTC operations in 1980, rule enforcement reviews became more than ever a headquarters function. Essentially, these reviews are scheduled, conceived, conducted, and written by Trading and Markets Division staff in Washington. The role of regional Trading and Markets Division staff in these

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1/In our 1978 report we recommended that CFTC establish uniform guidelines for conducting rule enforcement reviews. The Commission responded in July 1978 that its staff would, by the end of that year, begin to draft procedural guidelines that would include guidance for testing exchange procedures, records, and files. These guidelines were finalized and adopted by the Trading and Markets Division in March 1981. The guidelines are being used for the first time in the ongoing review of the New York Futures Exchange rule enforcement program.

reviews has been correspondingly reduced. Some regional staff told us that this role now amounts to little more than a support and data-gathering function. Despite centralization, however, the number of Trading and Markets Division positions assigned to the regions has not been appreciably reduced, resulting in a situation that one Commissioner described as chronic overwork of headquarters Trading and Markets staff and chronic underuse of division field staff.

Regional staff are close to the exchanges, are familiar with exchange operations and exchange personnel, and can make frequent on-the-spot inspections and verifications of exchange procedures and records. Therefore, regional staff ought to be able to contribute substantially to rule enforcement reviews. Indeed, such a contribution was envisioned by the Trading and Markets Director who, in March and April 1979, presented his recommendations to the Commission for an improved rule enforcement review process. Under his proposal, descriptive data on exchange compliance programs would be supplied in large part directly by the exchanges, while evaluations of the effectiveness of exchange rule enforcement would be performed by Trading and Markets staff, especially those in the field. Because these proposals were only partially implemented and because the succeeding Director of the Trading and Markets Division chose to emphasize a different approach to rule enforcement reviews, the projected benefits of greater regional staff involvement have not materialized.

In view of the severe budget limits facing CFTC, it must use all staff resources effectively. We believe that it is possible to enhance the effectiveness of rule enforcement reviews by better utilizing the knowledge, experience, abilities, and unique situation of regional staff. If this is not possible, CFTC needs to consider reallocating regional positions to headquarters where they may be used more effectively.

WHAT RULE ENFORCEMENT REVIEWS TELL US ABOUT THE CURRENT STATE OF EXCHANGE SELF-REGULATION

CFTC's rule enforcement reviews have revealed serious weaknesses in exchange self-regulatory programs. However, we found that these reviews do not serve as good indicators of the current state of exchange self-regulation; that is, they do not assess comprehensively the actual operational effectiveness of exchange rule enforcement. The reasons for this include the heavily descriptive quality of rule enforcement reviews (their frequent emphasis on the apparatus of self-regulation rather than its actual functioning), the lack of comprehensiveness of many reviews in terms of coverage of Regulation 1.51 subprograms, and wide variations in the quality and thoroughness of reviews. This last factor reflects, among other things, the primary purpose for which the review was made and the total staff resources devoted to the review. Some so-called rule enforcement reviews, performed for limited purposes such as contract market designation, are conducted rather quickly and with minimal expenditure of staff effort. However, these reviews can say relatively little about the quality of exchange self-regulation and, in fact, may raise unfounded conclusions, as the following example illustrates.

Comparison of the findings of the New York Mercantile Exchange compliance review with results of a CFTC enforcement investigation

Perhaps the most striking example of the weaknesses of an essentially descriptive and limited purpose rule enforcement review is the May 23, 1980, report by the Trading and Markets Division of its review of the New York Mercantile Exchange's rule enforcement programs. This report was based on a brief 3-day visit to the exchange and involved only 239 hours of staff time, from actual field audit work through drafting of the final report. It contained conclusions regarding the New York Mercantile Exchange's rule enforcement program that differed substantially from the findings of a 1977-81 CFTC Enforcement Division investigation into the exchange's compliance activities.

The stated purpose of the 1980 review was to determine whether the New York Mercantile Exchange had a rule enforcement program and, if so, whether that program satisfied the minimum standards of compliance with Regulation 1.51. In its review, the division limited itself to examining the exchange's compliance with five subprograms of Regulation 1.51: its programs for market surveillance, surveillance of trade practices, handling and investigations of customer complaints, disciplining of exchange rule violators, and recordkeeping. Particular attention was given to exchange market surveillance activities in the then current potato contract. This reflected a history of problems in potato futures trading at the exchange.

The review report concluded that the exchange's compliance program "apparently meets acceptable minimum standards" and that no further action was required. Regarding the exchange's market surveillance activities, the report concluded that "the Exchange has an acceptable market surveillance program," in fact, one that was quite "strong" in certain important respects. In the case of surveillance of trading practices, including surveillance of floor trading, the report concluded that the exchange did have a program but that certain "deficiencies do exist." One of the weaknesses noted was that the same exchange personnel were responsible for trade practice investigations and financial surveillance. On the other hand, the report praised the exchange's "highly accurate" chronological record of trades, which enabled the exchange compliance staff to conduct investigations into a variety of possible trade practice abuses such as wash trades, accommodation trades, cross trades, brokers trading ahead of customers, and trading outside the daily trading range. 1/ The report also noted that exchange staff familiarized themselves with individual brokers' trading patterns.

Regarding the exchange's investigation files, the report noted that, for the most part, they were properly documented and contained the necessary source material. In connection with the handling and investigation of customer complaints, the report noted that complaint processing was conducted promptly and that, when applicable, complainants were notified of their right to arbitrate the dispute.

Finally, in the case of the exchange's handling of disciplinary actions against violators of its rules, the staff reviewed two categories of exchange disciplinary activities: (1) penalties imposed by the business conduct committee for violations of exchange rules and (2) fines assessed by the floor committee for breaches of decorum rules. The division's report concluded in both instances that the exchange's program was satisfactory.

This rule enforcement review of the New York Mercantile Exchange was performed by CFTC's New York regional office. It was the result of a "surprise" visit to the exchange by Trading and Markets Division staff from April 30 to May 2, 1980, and included interviewing exchange officials and staff, reviewing the minutes of board of governors and exchange committee meetings, and examining exchange investigative files and other exchange records and documents. The review covered the period from July 1, 1979, through May 2, 1980.

While CFTC's Trading and Markets Division was reviewing compliance procedures at the New York Mercantile Exchange, CFTC's Enforcement Division was investigating trading activities on the exchange--an investigation which would produce quite different conclusions concerning the quality of the exchange's rule enforcement program and its compliance with statutory requirements and CFTC regulations. This investigation covered many of the same Regulation 1.51 subprograms that were examined in the Trading and Markets Division's rule enforcement review and found to be in satisfactory compliance, including exchange programs for (1) surveillance of trading practices, (2) investigations, (3) taking disciplinary actions against rule violators, and (4) recordkeeping.

The Enforcement Division's investigation originated in referrals from CFTC market surveillance staff who had become suspicious of possible trade practice abuses in trading of the exchange's 400-ounce gold contract. In February 1978 the division recommended and the Commission approved a formal order of

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1/These terms are defined in the glossary.

investigation relating to these and other apparently violative transactions. Subsequent analysis indicated possible trade practice violations in other contracts, and on February 9, 1979, the Commission authorized an expansion of the investigation. The investigation was further expanded on September 5, 1979, as the seriousness and extent of suspected violations became clearer.

These investigations revealed a wide-scale pattern of noncompetitively executed trades, wash sales, fictitious transactions, accommodation trades, cross trades, and bucketing (see glossary) in the 400-ounce gold contract during the period November 14, 1977, through January 25, 1979. The same pattern appeared in the trading of the exchange's silver coin contract from October 1977 through January 1979. The alleged motives of these violative transactions, according to the Enforcement Division complaint, were to (1) accomplish tax deferral objectives, (2) cheat customers, (3) create a false impression of market activity, and (4) pass money between accounts for varying purposes.

As a result of its investigation, the Enforcement Division questioned the economic purpose and/or public interest in continued trading of these two contracts, even going so far as to question the continuing designation of the New York Mercantile Exchange as a contract market in any commodity. The division noted that it appeared that the exchange's rule enforcement program was inadequate to effectively protect the integrity of its futures markets and, consequently, the investing public. This inadequacy resulted in the exchange's failure to enforce its rules--a condition of its continuing designation.

On December 23, 1980, the Commission authorized the Enforcement Division to hold in abeyance actual commencement of an administrative proceeding against the exchange and to undertake negotiations in an effort to reach a settlement with the exchange. Nearly 7 months later, on July 20, 1981, CFTC announced that an administrative proceeding had been filed against the exchange and that the Commission had simultaneously accepted an offer of settlement submitted by the exchange in connection with the alleged violations.

In its complaint, the Enforcement Division alleged that the exchange had failed, among other things, to:

--Secure compliance with its own bylaws, rules, and regulations as required by the act (including failure to conduct adequate surveillance of trading practices and failure to take prompt and effective disciplinary action against rule violators).

--Keep full, complete, and systematic records as required by CFTC regulations and the act.

—Enforce the terms and conditions of its contracts as well as other trading requirements.

—Meet various aspects of the public interest requirements of the act.

The Commission's July 20, 1981, opinion and order accepting the exchange's settlement offer provided that the exchange pay a civil monetary penalty of $200,000 (the largest ever assessed against any exchange), that two of the exchange's contract market designations be revoked, and that trading in 12 dormant exchange contracts not be recommenced without prior CFTC approval. The Commission also ordered the exchange to cease and desist from failing to enforce its own rules and required it to comply with several undertakings, including directing its recently established compliance review committee to thoroughly examine the exchange's surveillance and enforcement procedures and report its findings to CFTC. The Commission's opinion and order noted that in recent months the exchange had acted to improve its compliance program. This action included, among other things, hiring a new exchange president, tripling the size of its compliance staff, upgrading its personnel, and significantly increasing the size of its compliance budget.

One of the actions the exchange took to improve its self-regulatory activities was to hire a senior CFTC enforcement attorney as vice president in charge of compliance activities. When we asked him how two divisions within CFTC could have arrived at such markedly different conclusions concerning the quality of the exchange's rule enforcement program, he could offer no explanation other than his understanding of the nature of the Trading and Markets Division's rule enforcement review process. His perception of this process was that the Trading and Markets Division looks "for the existence of a program rather than testing and evaluating it for effectiveness." In his view, this process fails to get at the facts behind surface appearances. He expressed surprise at the conclusions reached by the division in its May 1980 report, because "[the exchange compliance program] really was in bad shape."

We believe that the differing conclusions reached by CFTC's Trading and Markets and Enforcement Divisions regarding the quality of the exchange's self-regulatory performance underscore the significance of the statement by the Director of the Trading and Markets Division that most exchanges now have at least the pretense of a self-regulatory program. While the Trading and Markets Division's 1980 review of the exchange was able to show that the exchange had much of the apparatus of self-regulation, that review did not involve the kind of investigation, testing, and evaluation that are required to determine whether the exchange had meaningfully embraced a commitment to self-regulation. This CFTC analysis and testing is essential if the agency is to get beyond pretense to the substance of self-regulation; that is, if it is to determine not only whether the self-regulatory mechanism is in place but also, and more importantly, how well that mechanism is operating.

CFTC NEEDS BETTER PLANNED, MORE THOROUGH, AND MORE COMPREHENSIVE RULE ENFORCEMENT REVIEWS

In 1978 we concluded that CFTC needed to place greater emphasis on performing timely and comprehensive rule enforcement reviews. We believed this emphasis was necessary to monitor the progress of self-regulation and to assure that exchanges comply with statutory requirements for rule enforcement. Continued close scrutiny of exchange self-regulatory programs would be needed, we concluded, until these programs could be demonstrated to be in full compliance with the act and CFTC regulations. We noted that CFTC's rule enforcement reviews up to that time, whatever their shortcomings, had amply demonstrated that "exchange self-regulation has a long way to go before it can be relied upon as an effective tool for regulating the futures markets."

Our present review disclosed that rule enforcement reviews are still not as timely or comprehensive as they should be and that a need still exists for substantial progress toward the goal of effective exchange self-regulation. We found a need for (1) better planning of the overall rule enforcement review program, (2) individual reviews to more effectively use limited CFTC resources, and (3) reviews to reflect the relative importance of factors such as exchange size and economic importance, the findings of prior reviews, and exchange attitude in making needed improvements.

Allocating necessary additional resources to rule enforcement reviews is justified, at least in the short run, by the crucial importance of exchange self-regulation to the commodities regulatory scheme the Congress envisioned and by the substantial resource savings and reallocations that become possible once truly effective exchange compliance programs can be achieved and documented. At the same time, more efficient resource use is possible through better planning and management of rule enforcement reviews. Additionally, resources for this essential activity could be made available with operational improvements and by transferring functions to industry participants, improvements that are discussed elsewhere in this report.

Infrequency of reviews and lack of effective followup have retarded progress toward better self-regulation

The expense in time and resources of rule enforcement reviews should not be used as a justification for not performing these reviews often enough to apprise the Commission of the state of exchange compliance with statutory and CFTC requirements and to assure it that exchanges are overcoming previously noted deficiencies. CFTC's rule enforcement review program is not currently accomplishing these two important purposes.

At a Commission meeting held on April 3, 1979, to discuss proposed modifications to the rule enforcement review program, the then Director, Trading and Markets Division, discussed shortcomings that he perceived in the program. "We simply do not know," he said, "whether or not, on a current basis anyway, [CFTC] regulations are being followed." He acknowledged that rule enforcement reports brought to the Commission are not timely and have "stale" findings. He believed that the division should be able to provide the Commission with an evaluation of the current state of an exchange's rule enforcement program but believed the division could not do so. He admitted that the division's knowledge of exchange programs was outdated and because of that, as well as the essentially descriptive character of its information, the division could not evaluate an exchange on even a minimal pass/fail basis.

The Director cited limited staff resources for rule enforcement reviews as one reason why the division did not have current knowledge about exchange programs. This was also cited as a reason why CFTC failed to do a followup review of the Chicago Board of Trade even though he doubted whether the exchange had improved since the 1978 CFTC review, which found numerous serious deficiencies.

The proposed program modifications, which included the continuous gathering of information through Regulation 1.50 "special calls" 1/ to exchanges were, for the most part, not adopted. In a July 24, 1979, Commission meeting the new (and presently incumbent) division director said that that his division did not have the resources to adopt the approach recommended in the March 20, 1979, memorandum. The division, he believed, could not keep its Regulation 1.51 reviews current in the manner proposed. As a result, it would be obliged to use another approach in which the division staff would concentrate on what it believed to be the weakest parts of an exchange program, based on data gathered to date. He hoped that by following this approach the division could conduct "mini rule enforcement reviews" each year.

We found that the adoption of the mini-rule enforcement review concept has not enabled the division to increase significantly either the frequency or the number of rule enforcement reviews it performs. We believe this is due in part to the fact that the concept has not always been applied rationally and consistently. Eleven rule enforcement review reports have been

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1/Regulation 1.50 special calls are special purpose requests for data from exchanges.

presented to the Commission since the July 24, 1979, meeting when the minireview concept was first proposed. One of these reported reviews consisted of examining the compliance program of a soon-to-be defunct exchange, the Amex Commodities Exchange. Two reports dealt with reviews of the proposed compliance programs of exchanges that had applied for initial designation, the New Orleans Commodity Exchange and the New York Futures Exchange. A fourth report dealt with the review of the New York Mercantile Exchange discussed earlier and found to have questionable conclusions. A fifth review consisted of a very narrowly focused special purpose review of the Kansas City Board of Trade's settlement price procedures and required only 287 staff hours to perform.

These five limited purpose and rather "special case" reviews aside, only six other review reports have been presented to the Commission since July 24, 1979. The total of nine rule enforcement reviews reported to the Commission in fiscal years 1980 and 1981 compared with a total of nine reported in fiscal years 1978 and 1979 and eight reported in the 13-month period between July 1976 and August 1977.

Comprehensive reviews are still needed to provide benchmarks for assessing exchange self-regulatory performance

Comprehensive rule enforcement reviews, dealing with each of the eight subprograms outlined in Regulation 1.51, are essential to provide the necessary benchmarks against which to measure exchange performance and to assess progress in upgrading exchange compliance programs over time. Such benchmarks are also needed to evaluate exchanges in relation to one another. Because Trading and Markets Division officials with whom we spoke expressed little confidence in the thoroughness, accuracy, and informative quality of rule enforcement reviews performed before they came to the division and because prior rule enforcement reviews, whatever their inherent weaknesses, have revealed serious gaps and shortcomings in exchange self-regulatory programs, it is essential that these reviews, for the time being at least, be thorough and comprehensive in scope.

In its July 14, 1978, response to our recommendations regarding rule enforcement reviews, the Commission stated its belief that "greater emphasis must be placed on performing in-depth, timely rule enforcement reviews of commodity exchanges," adding that such "reviews are one of the principal tools for bringing about effective self-regulation." The Commission went on to say that it expected to conduct reviews that are thorough and constructively critical of exchange rule enforcement programs. It also said that while it would continue comprehensive reviews it would, in appropriate instances, concentrate reviews upon previously identified deficiencies as a way of making more efficient use of staff resources.

Although we agree with the Commission that it may be appropriate in particular instances to concentrate reviews on previously identified deficiencies, we found several instances where this was not done--where areas found to be seriously deficient in one rule enforcement review were not examined in a subsequent rule enforcement review. The Trading and Markets Division's latest review of the Chicago Board of Trade provides the most striking example of this. Most notable about this compliance review, aside from its lack of timeliness, is its very limited scope--it only reviewed two of the eight subprograms listed under Regulation 1.51. 1/ This limited coverage is difficult to reconcile with the size and economic importance of this exchange and with the serious across-the-board deficiencies CFTC found in its January 1978 report on the exchange's compliance program. (See app. XIV.)

The Chicago Board of Trade is the world's largest commodity exchange. In 1981 the exchange's trading volume of 49,085,763 contracts constituted 49.8 percent of the total trading volume on all U.S. exchanges. The division's 1977 review of the exchange's compliance program found serious deficiencies in five of the seven Regulation 1.51 subprograms examined. For example, six serious deficiencies were found in market surveillance, including little concern for price artificiality and economic movement of the cash commodity caused by attempted manipulation and a restrictive attitude toward staff independence. Regarding trade practice surveillance, the exchange was found to be in violation of CFTC requirements because it failed to perform surveillance of any of the seven categories of trade practice abuse listed under Guideline II and because of inaccuracies in recorded trade data. Regarding the investigation of customer complaints, CFTC found numerous deficiencies including trade register inaccuracies, unclear investigative procedures, and ineffective disciplinary action. Finally, CFTC found the exchange to be in violation of requirements for taking prompt and effective disciplinary action against exchange rule violators, having neither established standards for evaluating evidence nor recorded reasons for disciplinary actions taken.

The extent and seriousness of the deficiencies revealed by the division's 1978 report on the Chicago Board of Trade, coupled with the expressed skepticism of Trading and Markets Division officials concerning the thoroughness and reliability of this and other early rule enforcement reviews, raise questions concerning the limited scope of the division's most recent review of the

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1/These are the subprograms dealing with market surveillance and surveillance of trading practices.

exchange. Additional questions are raised when the narrow focus of this compliance review is contrasted with the comprehensiveness of the division's review of the Chicago Mercantile Exchange, an exchange whose compliance program CFTC declared in late 1977 to be aggressive, innovative, and prompt--the most effective exchange program examined to date.

Asked about the different approaches taken on the Chicago Board of Trade and Chicago Mercantile Exchange compliance reviews, Trading and Markets Division officials cited resource constraints. As a general comment and echoing the CFTC's July 1978 response to our recommendations, division officials told us that the division had altered its approach to rule enforcement reviews to eliminate "across the board" reviews and instead focused the reviews on particular areas where (1) they believed or suspected that there may be problems or (2) prior rule enforcement reviews had revealed problems. However, both the comprehensive Chicago Mercantile Exchange review and the narrow Chicago Board of Trade review would appear to contradict this stated policy, or at least stand as conspicuous exceptions to it.

In June 1981 the Deputy Director and Assistant Director of the Trading and Markets Division told us that in the future there would be very few comprehensive reviews of exchanges previously reviewed comprehensively. The division's resources would not permit both comprehensive reviews and frequent reviews. They preferred more frequent reviews as a means to "keep on top" of the exchanges so that they do not need to be reviewed comprehensively in the future. As noted, however, the frequency of rule enforcement reviews has not measurably increased despite the more narrowly focused approach, and the limited approach itself has not been used rationally and consistently.

In subsequent discussions with division officials about the disparate Chicago Board of Trade and Chicago Mercantile Exchange reviews, we were given various explanations for the different approaches followed. One official told us that the division staff had anticipated that a much greater effort would be required to review the Chicago Board of Trade because of the seriousness and extent of the problems disclosed in the 1977-78 review. Because of this and because there was no reason to believe that the deficiencies had been corrected in the intervening 4 years, the staff believed it would take much time and effort to document a comprehensive review of the exchange. In the case of the Chicago Mercantile Exchange, however, given the generally high marks it received in its 1977 review, division officials expected that a comprehensive rule enforcement review would be relatively easy to perform and document.

CFTC records for fiscal years 1980, 1981, and the first two quarters of 1982 reveal that the limited scope review of the Chicago Board of Trade had consumed 21 months and 5,598 staff hours as of March 31, 1982. The comprehensive review of the

Chicago Mercantile Exchange's compliance program had taken 17 months and 4,015 staff hours as of the same date.

We asked whether Trading and Markets Division officials might have intended the comprehensive review of the Chicago Mercantile Exchange and the expected findings of that review to serve as standards against which other exchange compliance programs might be judged. A senior CFTC official replied that that had not been the division's intention or expectation. If the division had intended to point to a "paragon," he said, it would not be the Chicago Mercantile Exchange. He added that he had read the "glowing report" of the division's 1977 review of the Chicago Mercantile Exchange with skepticism and noted that earlier rule enforcement review reports gave only an overview of an exchange's compliance program; they were not as detailed or as well documented as the reports written now.

A CONTINUED NEED EXISTS FOR IMPROVED CRITERIA BY WHICH TO ASSESS EXCHANGE RULE ENFORCEMENT PROGRAMS

In 1978 we recommended that CFTC revise Guideline II to provide a clearer, more specific set of standards by which to evaluate exchange compliance programs. We noted that Guideline II, although intended as an expansion and elaboration of Regulation 1.51 was, nevertheless, quite general and did not provide either (1) the specific guidance to exchanges that would help them clearly understand CFTC's requirements or (2) the objective criteria that would help CFTC evaluate exchange rule enforcement programs. We reported that Guideline II had been hurriedly prepared in 1975 and had never been revised. We also reported that CFTC officials at the time agreed with us that the Guideline needed a major overhaul. An April 4, 1978, memorandum from CFTC's Office of Policy Review also encouraged the Commission to strengthen its rule enforcement review program and suggested that it was time for a complete reassessment of Guideline II and Regulation 1.51. It noted that while the rule enforcement review program was one of CFTC's most important activities, it was "weak in terms of standards and criteria."

CFTC's July 14, 1978, response to our recommendation stated that the Commission had considered our recommendation at an April 5, 1978, meeting and had concluded that Guideline II did not require revision, that, in fact, it did provide a sufficiently clear and objective standard by which to measure the adequacy of an exchange's rule enforcement program. Our examination of the record of that meeting and CFTC documents and our discussions with CFTC officials indicate that the primary reason for not revising Guideline II and Regulation 1.51 has to do with a preference for the flexibility that a generally written guideline provides. CFTC believes this flexibility takes into account the differences among exchanges, such as size, trading volume, and nature of trading. According to the present Director of the

Trading and Markets Division, CFTC's belief concerning the Guideline II revision was that an attempt to get any more specific in the criteria would probably necessitate a separate guideline for each exchange.

Flexibility not incompatible with more specific and objective criteria

We do not agree with CFTC's conclusion that further refinement and elaboration of Regulation 1.51 requirements is unnecessary. We believe that CFTC has had difficulty achieving rapid progress in upgrading exchange rule enforcement programs and stating clearly whether exchanges are complying with their self-regulatory requirements in large part because its own standards for compliance are so vague. We believe that in most, if not all, of the programmatic areas covered by Regulation 1.51, CFTC can and should develop more specific and objective standards that would not only provide more helpful guidance to exchanges but would also provide the specific criteria CFTC needs to effectively judge exchange performance. We believe, moreover, that such criteria can be developed while still retaining the flexibility to take into account substantive differences among exchanges. This would allow for appropriately different treatment of exchanges such as the Minneapolis Grain Exchange and the Kansas City Board of Trade on one hand and the Chicago Board of Trade, the Chicago Mercantile Exchange, and the Commodity Exchange, Inc., on the other.

Finally, revising Guideline II is not the only way CFTC can provide more specific criteria to assess exchange self-regulation. In addition to providing more specific guidance concerning what it believes is necessary in the way of exchange programs for market surveillance and surveillance of trading activity (to mention only two of the eight areas covered in Regulation 1.51), the Commission can also make effective use of its rulemaking power and its authority to review and approve exchange rules to provide the kinds of specific standards and assessment criteria which we believe are needed.

Guideline II can be made more specific

The example of market surveillance illustrates how we believe Guideline II might be revised to provide better guidance to exchanges and more specific criteria for CFTC use in judging exchange programs. Guideline II covers several aspects of market surveillance including collection of large-trader position data. It states that adequate exchange market surveillance should include surveillance of (1) price movements, (2) changes in price relationships--among futures, between markets, and futures vs. cash, (3) open interest and changes therein, (4) volume of trading and changes therein, (5) trading liquidity and the magnitude of successive price changes, and (6) market news and gossip. No further elaboration of the detail, frequency, or form in which this information is to be collected or analyzed is given in the guideline.

In contrast, CFTC has established detailed procedures for its own economists to use in designing and organizing a daily market surveillance program. CFTC's internal market surveillance guideline places considerable emphasis on understanding the production, supply, demand, and marketing characteristics of the underlying cash commodity. It makes clear that relating an understanding of these market forces to traders' actions in futures markets gives a rounded picture of the commodity market. The guideline also specifies what data series must be maintained and when data collection should begin in order to make available a complete data base sufficiently in advance of the expiration of the contract to permit detection of potential market problems.

Also, as noted previously, in October the Trading and Markets Division adopted a procedures manual for the conduct of rule enforcement reviews. This manual goes into considerable detail on the quantity and timing of data that exchanges should collect regarding large traders, deliverable supply, and cash and futures price relationships. The manual also directs division staff to determine whether (1) the exchange has a procedures manual for market surveillance, (2) any training program exists for new market surveillance personnel, and (3) the staff has the independence to pursue potential market problems.

Revising Guideline II to include the detail in CFTC's own internal surveillance guidelines and the rule enforcement review procedures manual would give exchanges a clearer view of what CFTC views as an adequate market surveillance program and would provide needed criteria for evaluating exchange surveillance activities.

Rulemaking authority provides an additional opportunity to clarify self-regulatory requirements and develop more specific standards

CFTC's authority under the act to promulgate rules and regulations it deems necessary is another way the agency can provide more specific guidance to exchanges concerning their self-regulatory responsibilities. At the same time, such rules and regulations and the quality of exchange compliance with them could provide a more precise and objective means of evaluating the quality of exchange self-regulation.

CFTC has several rules that impose specific obligations on exchanges and that relate to various regulatory subprograms enumerated in Regulation 1.51. At the time of our 1978 review, for example, CFTC had pending a set of rules dealing with exchange disciplinary procedures (subprogram 7 of Regulation 1.51). We recommended that the Commission adopt and implement these rules to deal with the kind of conflict of interest potential that is inherent in the operation of exchange disciplinary committees. The Commission adopted these rules entitled "Exchange Procedures for Disciplinary, Summary and Membership Denial Actions" on January 17, 1979. Another set of rules relating to exchange self-regulatory responsibilities under Regulation 1.51 are CFTC's rules entitled "Arbitration or Other Dispute Settlement Procedures." These rules relate closely to the requirement under Regulation 1.51 that exchanges investigate complaints received from customers concerning the handling of their accounts or orders.

The Commission's adoption in September 1981 of rules that require all exchanges to impose speculative position limits on commodities that do not presently have such limits constitutes another example of how the Commission can use its rulemaking authority to upgrade exchange compliance programs and at the same time provide more objective criteria with which to assess these programs. In evaluating exchange market surveillance in the future, CFTC will be able to look at how exchanges monitor and enforce speculative limits as an additional index of the quality of exchange self-regulation.

A less successful example of using rulemaking to support the purposes of Regulation 1.51 and to clarify exchange self-regulatory requirements was the Commission's handling of rules relating to the time-sequencing of exchange trading activity. In our 1978 report we discussed the importance of trade record accuracy and time-sequencing of trades to make possible the investigations needed to detect and punish various types of trade practice abuses. We noted that the ability to detect and to investigate trading abuses is heavily dependent on the ability of the investigator (either an exchange or CFTC) to reconstruct trading after the fact. We recommended, among other things, that CFTC study the feasibility, costs, and benefits of a system for precise time-sequencing of all trades and, if such study showed timesequencing to be feasible and cost-effective, to adopt and enforce time-sequencing regulations.

CFTC's Regulation 1.35(g)(1) required exchanges to show on the record of each futures trade the mechanically or electronically verified time of execution to at least the nearest minute. This regulation would have gone far toward enhancing the exchanges' and CFTC's ability to perform investigations of suspected trade practice abuses and would have provided valuable support as well as evaluative criteria for several exchange self-regulatory responsibilities under Regulation 1.51 (for example, subprogram 2, surveillance of trading practices; subprogram 5, investigation of alleged or apparent violations; and subprogram 8, regarding the requirement to keep full, complete, and systematic records).

Despite the clear benefits that this regulation would have provided, and despite the fact that several exchanges had demonstrated a willingness and ability to achieve the time-sequencing standard, the Commission reacted to exchange opposition and decided, by a vote of 3 to 1, to defer indefinitely the requirement of 1-minute time-sequencing. In its place, the Commission substituted a requirement that each contract market divide its trading day into consecutive, separately identified time periods of no more than 30 minutes in length.

CFTC could use rule review and approval authority to provide improved criteria for evaluating exchange self-regulation

CFTC's authority under the act to review and approve and in some cases to modify exchange rules could also be used in particular circumstances to upgrade exchange self-regulation and to provide more specific standards for judging exchange self-regulatory performance. One recent example of this was the Commission modification of an arbitration rule of the Chicago Board of Trade in order to bring this rule into compliance with CFTC's own rules--specifically, the requirement that arbitration of claims under $15,000 be compulsory for exchange members if the aggrieved customer so elects. 1/

CFTC could probably make greater use of its rule review authority, particularly in the case of applications for contract market designation. CFTC could require exchanges to supply whatever information it believes may be needed to evaluate the exchange's affirmative rule enforcement program and the potential impact on that program of approval of the proposed contract. As an example, CFTC could require detailed information concerning surveillance practices, recordkeeping, staffing, and procedures. It could also require that exchange rules be drafted to provide for whatever specific monitoring, surveillance, recordkeeping, and investigation it deems necessary in connection with the proposed contract.

CONTRACT MARKET DESIGNATION NEEDS TO BE MORE CLOSELY LINKED WITH EXCHANGE ADHERENCE TO SELF-REGULATORY REQUIREMENTS

In 1978 we recommended that the Commission establish and implement a strict policy of designating additional contracts on exchanges only when it has determined that the applicant exchange has met all statutory and CFTC-imposed requirements, in

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1/This matter, presently in litigation, is discussed more fully in ch. 8.

particular the requirement that the exchange maintain an affirmative rule enforcement program. The link between contract market designation and fulfillment of self-regulatory obligations is specifically envisioned in the language of the act (in particular, sections 5, 5a, and 6) and can be considered the principal positive incentive (as opposed to the essentially negative, punative incentives provided in section 6b) for encouraging exchanges to meet self-regulatory responsibilities. The power to grant, withhold, and revoke contract market designation is unquestionably one of the most valuable and powerful tools that CFTC possesses to ensure compliance with statutory and agency-imposed requirements and to upgrade industry self-regulation, which is a prerequisite to adoption by CFTC of an essentially oversight role regarding the exchanges.

CFTC has not used the leverage available in contract market designation to improve rule enforcement

In its response to our 1978 recommendation, the Commission stated that it had consistently adhered to its statutory obligation in designating contract markets for futures trading and intended to continue to do so. It added that it was particularly cognizant of its requirement that exchanges maintain an affirmative rule enforcement program to be designated for additional futures contracts and, further, that if it should determine that an applicant exchange has not met the necessary preconditions for designation, it would not designate that exchange as a contract market.

In fact, the Commission has never exercised its authority to deny contract market designations, despite the serious deficiencies in exchange compliance programs revealed by post-1978 rule enforcement reviews and despite the widely held and frequently expressed misgivings of Trading and Markets Division staff concerning the quality and reliability of earlier rule enforcement reviews, particularly as they purport to be evaluations (as opposed to descriptions) of exchange compliance programs. In only one recent case, the July 20, 1981, settlement with the New York Mercantile Exchange, has the Commission exercised its authority to revoke existing contract market designations. Shortly after this, on August 4, 1981, and then again on September 1 and October 27, 1981, the Commission acted to approve five applications for initial contract market designation on the exchange. The Commission approved these applications while, in the consensus of its members, it was not yet possible to determine whether the exchange had developed an affirmative rule enforcement program which satisfied all important statutory and CFTC requirements.

In addition, the Commission has designated additional contracts on several other exchanges where rule enforcement reviews have revealed serious shortcomings in the exchanges' compliance programs. For example, the Commission designated eight additional futures contracts for trading on the Chicago Board of Trade after the January 1978 reporting of its first rule enforcement review of that exchange. In the case of the Commodity Exchange, Inc., the Commission designated two contracts after two successive rule enforcement reviews had disclosed serious deficiencies in the exchange's compliance program.

An October 30, 1978, memorandum from the then Director of the Trading and Markets Division to the Commission discussed our 1978 recommendations in some detail, including the recommendation relating to contract market designation. The memorandum stated that the division agreed with the "thrust" of our recommendations but acknowledged that "exchanges have been granted additional contract market designations with reported deficiencies in their compliance programs." The memorandum stated the division's view on the appropriate approach to the issue of compliance when an exchange is requesting additional contract market designation. This approach is to determine whether the exchange is in "substantial compliance" with its rule enforcement responsibilities even though the Commission does not believe that it could safely adopt a purely oversight role regarding the exchange's rule enforcement efforts. Essential to this determination, according to the memorandum, was the "attitude" of the exchange; that is, if the exchange were making substantial and effective efforts to become self-regulatory and if it were found to be in substantial compliance, then contract market designation could be favorably considered. This, it was believed, was something on which CFTC staff should make recommendations and the Commission make decisions, as particular instances arise.

Our review of Commission documents and meeting records revealed that the question of how to effectively link self-regulatory performance and contract market designation is one which continues to trouble CFTC. For example, at a July 24, 1979, Commission meeting one Commissioner observed that "unless we have some way of keeping current on rule enforcement there is no way that we are going to ever tie rule enforcement with contract market designation." Our review disclosed that the Commission and its staff have not yet found a way to keep current on exchange rule enforcement. We believe this factor, as much as any other, explains its reluctance to use its authority to deny contract market designation.

Proposed Guideline I revisions would help make more explicit the link between designation and rule enforcement and would help CFTC evaluate exchange compliance programs

The proposed revisions to CFTC's Guideline I discussed in chapter 3 provide a means not only to clarify the linkage between contract market designation and exchange rule enforcement, but also to enhance CFTC's ability to keep current in its assessment of exchange self-regulatory programs. One provision of the rules, proposed in late 1980, was a requirement that exchanges submit evidence that would satisfy public interest considerations under the act. Included in this requirement would be the necessity of an exchange to demonstrate, with relevant evidence, the adequacy of its affirmative rule enforcement program. Such evidence would include a description of any changes in its compliance program introduced since the last CFTC rule enforcement review.

We believe that these proposed rules could be an important adjunct to the Trading and Markets Division's rule enforcement review program, particularly if CFTC were to insist upon specific and well-documented evidence of the assertions made by exchanges concerning their compliance programs and surveillance procedures. One way to accomplish this, particularly in cases where CFTC has strong reason to question the quality of an exchange's rule enforcement efforts, would be to require an independent audit and evaluation of the exchange's program similar to the evaluation required under the Commission's July 20, 1981, settlement with the New York Mercantile Exchange. These outside reviews, performed at the exchanges' expense, could be tailored to CFTC's concerns and as broadly or narrowly focused as necessary to meet CFTC's information requirements. Although they could not take the place of CFTC's own rule enforcement reviews, they could go far toward overcoming the persistent problem of maintaining current CFTC assessments of exchange self-regulation.

As noted in chapter 3, the Commission has taken no action on these proposed rules since the close of the comment period in February 1981. Moreover, whether any action will be taken remains doubtful. We believe that CFTC needs to take this valuable opportunity to explicitly link contract market designation with exchange satisfaction of self-regulatory responsibilities.

CONCLUSIONS

We found that CFTC has improved rule enforcement reviews by installing more formalized review procedures and by better documenting and illustrating findings. However, rule enforcement review reports continue to be primarily descriptive. These reviews often focus on the form of exchange self-regulation rather than on the substance of rule enforcement. To some extent, this orientation has been dictated by the need to focus first on getting the exchanges to put the requisite self-regulatory systems in place. However, now that most exchanges have installed the machinery of self-regulation, CFTC needs to evaluate how well this machinery is working.

Followup on rule enforcement review recommendations is weak. Followup often does not occur until subsequent rule enforcement reviews, which CFTC itself frequently refers to as "follow-up" reviews. This approach means that the agency must often wait 2, 3, or 4 years (until the time of its next review) to determine whether the exchange has actually corrected an identified problem.

Despite the vital importance of rule enforcement reviews, our review disclosed that the Trading and Markets Division has devoted a declining percentage of its staff resources to this activity. This decline dates from the centralization of CFTC management in fiscal year 1980 and has overburdened headquarters staff while resulting in underuse of regional staff. We also identified instances where CFTC staff skills that were clearly useful in assessing exchange compliance programs have not been used to improve the efficiency and effectiveness of rule enforcement reviews.

CFTC continues to have weaknesses in planning, scoping, and scheduling rule enforcement reviews. Some of the pertinent factors which, in our view, have been given insufficient attention in planning and scheduling reviews are the elapsed time since the prior review of an exchange, the nature and seriousness of the deficiencies disclosed in prior reviews, the nature and extent of agency followup on corrective action taken, and the size and economic importance of the exchange (in terms of trading volume and number of contracts traded).

Several of the weaknesses observed in the rule enforcement review program are, we believe, attributable to insufficient Commission attention to and support of this important function. We found that the Commission now has no meaningful involvement in a review until the final report is presented to it for its consideration.

As in our 1978 review, we found a strong need for the kind of specific standards and objective criteria that would provide better guidance to exchanges in organizing and operating their rule enforcement programs and at the same time facilitate CFTC's task of evaluating these programs. CFTC has not adopted the revisions to its Guideline II that we recommended in 1978, apparently because it preferred the administrative flexibility that a generally worded guideline provides. We believe that flexibility is not incompatible with more specific and objective criteria and that Guideline II can be considerably improved. CFTC's rulemaking authority and its authority to review, approve, and modify exchange rules provide additional opportunities to clarify and specify exchange self-regulatory requirements.

We continue to believe that linking contract market designation and rule enforcement constitutes the most effective means CFTC has at its disposal to stimulate a greater exchange commitment to self-regulation and to upgrade self-regulation over time. Improvements to the rule enforcement review process that we have identified, as well as improved criteria for assessment of exchange compliance programs, would go far in facilitating this link.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To improve CFTC's ability to effectively monitor the quality of exchange self-regulation and to provide the necessary upgrading of exchange rule enforcement programs, we recommend that the Commission:

--Reallocate its resources to provide greater support to the rule enforcement review program.

--Provide necessary attention and oversight to the rule enforcement review program, including guidance in the planning, scoping, and scheduling of reviews; monitoring the progress of reviews; and ensuring the timely completion and reporting of reviews.

--Place greater emphasis on reviews that cover carefully selected aspects of exchange activities but only after a period of comprehensive reviews has established that exchanges have effectively functioning self-regulatory programs.

--Increase the frequency of selective reviews once the transition from comprehensive reviews has been accomplished.

--Establish substantive followup procedures to ensure that exchanges correct identified rule enforcement deficiencies with reasonable promptness. The procedures should include setting firm deadlines for taking corrective action, verifying the actions taken as well as their sufficiency, and imposing penalties pursuant to section 6(b) of the act for failure to meet deadlines.

--Supplement the rule enforcement review process with a requirement that exchanges provide necessary evidence to demonstrate that their compliance programs satisfy statutory and CFTC requirements. In appropriate cases, particularly where strong doubts exist concerning an exchange's compliance with self-regulatory requirements, CFTC could ask the exchange in question to produce an independent outside audit of its compliance program following CFTC guidelines.

--Develop more specific standards for exchange self-regulatory programs and more objective criteria to assess exchange self-regulatory performance. This may be accomplished through revisions to Guideline II, rulemaking, and review and approval of exchange rules.

--Establish a firm link between contract market designation and compliance with exchange rule enforcement responsibilities, designating additional contracts only on those exchanges able to demonstrate satisfactory compliance with self-regulatory responsibilities. This link can be facilitated by adopting proposed revisions to Guideline I, which would give long-needed substance to the statutory test of public interest.

AGENCY COMMENTS AND OUR EVALUATION

CFTC had detailed comments concerning our discussion of the rule enforcement review program. CFTC grouped its comments into two categories: (1) a series of five "major points" and (2) a series of ten other comments relating to what CFTC perceived to be "specific inaccuracies" in our report. For ease of reference to the full text of CFTC's comments (in app. XV), we have followed CFTC's numbering system in discussing and responding to its comments on this chapter.

CFTC's major point number 1

CFTC took exception to some of our statements concerning the descriptive nature of rule enforcement reviews. Specifically, CFTC stated that we did not adequately acknowledge that its most recent reviews have gone considerably further than previous reviews in providing specific documentation designed to assess the operational effectiveness of exchange programs. CFTC maintained that the planning, conduct, and reports associated with recent reviews have all been directed toward evaluating exchange investigations and systems and presenting that documentation in the reports to the Commission.

We do recognize in our discussion some recent improvements in the documentation of findings in rule enforcement reviews. For example, we state that since our 1978 review CFTC has improved its reviews by providing more thorough documentation and support of review findings. We would also acknowledge that two reviews completed after we provided our draft report to CFTC for comment contain an increased level of evaluative data.

Our assessment that rule enforcement reviews continue to be heavily descriptive in nature is based on an examination of all rule enforcement reviews conducted and reported since our last examination of CFTC's rule enforcement review program in 1978. Despite some promising signs that rule enforcement reviews may be becoming more analytical and evaluative, our overall appraisal for all reports issued since 1978 remains that reviews have continued to focus on the form and appearance of exchange self-regulation (organization, staffing, procedures, etc.) rather than on the operational effectiveness of exchange self-regulatory activities.

CFTC's major point number 2

(a). CFTC stated that our report ignores the extremely limited nature and scope of the Division of Trading and Markets' review of the New York Mercantile Exchange and the reasons for conducting the review. As evidence of the limited scope of the review, CFTC pointed out that the entire staff work on the review consumed only 240 hours, whereas more "typical" rule enforcement reviews have consumed as much as 2,000 staff hours. CFTC also noted that the Division of Trading and Markets' May 12, 1980, memorandum to the Commission states that the review "was not structured to be a full scale rule enforcement review or to eliminate the need for such review in the course of the Division's ongoing rule enforcement program." CFTC stated that the division initiated the review specifically in light of its knowledge of the Division of Enforcement's investigation into trading and compliance activities at the exchange because the Commission at that time (April-May 1980) was to consider major changes designed to eliminate serious and recurring problems in the exchange's potato contract. As evidence of this, CFTC pointed out that the rule enforcement review report focuses substantially on the exchange's surveillance capabilities regarding potato futures trading.

We are in complete agreement with CFTC regarding the "limited nature," "limited depth," and "limited scope" of the New York Mercantile Exchange rule enforcement review. We are reporting that rule enforcement reviews vary widely in coverage and thoroughness. We point out that such variations often reflect the primary purposes for which the reviews are made and the total staff resources devoted to the reviews. Some "so-called rule enforcement reviews" performed for limited purposes (such as contract market designation or rule approval) are conducted quickly and with minimal expenditure of staff effort. Whatever other purposes they may accomplish, we note, such reviews can say relatively little about the overall quality and effectiveness of exchange self-regulation and may give rise to unfounded conclusions.

Specifically, we note that the New York Mercantile Exchange rule enforcement review was (1) performed very quickly (between April 30 and May 2, 1980) and (2) with minimal expenditure of staff effort--239 staff hours. We try to put the review in perspective in terms of resource expenditure by comparing it with the Kansas City Board of Trade rule enforcement review, which consumed 287 staff hours, and with the Chicago Board of Trade and Chicago Mercantile Exchange rule enforcement reviews, which as of March 31, 1982, had consumed 5,598 and 4,015 staff hours, respectively. In addition, in appendix XIV we provide a complete listing of all rule enforcement reviews performed by CFTC with an indication, in every case where data was available from CFTC, of the total staff resources devoted to each review. This comparative presentation provides a full and sufficient context for consideration of the 1980 New York Mercantile Exchange review.

As far as CFTC's reasons for performing the 1980 New York Mercantile Exchange rule enforcement review are concerned, in this case, as in the case of all other rule enforcement reviews which we discuss, we allowed the staff report of the review to speak for itself. We considered the May 23, 1980, report to be exactly what the report purports to be, namely a report on an "inspection of the New York Mercantile Exchange rule enforcement program."

We do not disagree with CFTC's statement that the New York Mercantile Exchange rule enforcement review coincided with and aided the Commission's consideration of important proposed rule changes at the exchange. As CFTC has noted, this fact is supported by documents CFTC staff provided to us during our review. It should be noted, however, that the rule enforcement review was one of the specific rule enforcement reviews that CFTC planned to perform in fiscal year 1980. It was, in fact, indicated on a list of nine planned fiscal year 1980 rule enforcement reviews provided to us by the Director of the Division of Trading and Markets on September 10, 1979--long before we began our audit work. The review, moreover, was completed and reported almost exactly according to the projected schedule, an exception among the rule enforcement reviews planned for fiscal year 1980.

(b). CFTC commented on our discussion that traced the origin of the 1981 enforcement action against the New York Mercantile Exchange to November and December 1977 reports by CFTC's New York regional office surveillance economists of possible violative trading in the exchange's 400-ounce gold contract. CFTC stated that the initial referral orginating from market surveillance in this matter was transmitted "jointly" to the Divisions of Enforcement and Trading and Markets. CFTC added that by memorandum dated February 2, 1978, both divisions agreed that the Trading and Markets Division would conduct the initial inquiry into the market surveillance referral. The Trading and Markets Division reportedly proceeded with its inquiry and presented its findings to the Division of Enforcement by memorandum dated June 9, 1978. It was the findings in this memorandum, CFTC stated, which were the basis of the Division of Enforcement's preparation of a formal order of investigation and of the ultimate complaint filed by the Commission.

CFTC's comments were prepared by its Division of Trading and Markets. The division stated that its purpose in recounting this history of the New York Mercantile Exchange enforcement action was solely to demonstrate that it had since early 1978 been involved in evaluating the rule enforcement capability of the exchange and had been continually aware of the status and findings of the Enforcement Division's investigation of the exchange.

The division's statements do not demonstrate an error or factual inaccuracy on our part. The additional information provided by CFTC shows, we believe, an important early contribution by the Division of Trading and Markets to preparing the groundwork for the Commission's initial order of investigation and subsequent complaint in the New York Mercantile Exchange matter.

Nevertheless, the record is clear that this matter did originate, as we state, in referrals from CFTC market surveillance personnel. Moreover, the record is also clear that the leading role in initiating and conducting investigations into suspected violative trades at the exchange was taken by the Division of Enforcement. It was these Enforcement Division efforts, primarily, which culminated in the Commission's July 20, 1981, complaint against the exchange and its simultaneous acceptance of the exchange's offer of settlement; and it was these efforts, not a rule enforcement review conducted by the Division of Trading and Markets, which revealed serious deficiencies in the exchange's overall program for rule enforcement. The fact that important self-regulatory deficiencies were revealed through an Enforcement Division investigation rather than as a result of a contemporaneous rule enforcement review performed by the Division of Trading and Markets constitutes one of the essential points of our discussion. As the Director of CFTC's Division of Enforcement told us on October 16, 1981, the Commission's case against the New York Mercantile Exchange "did not come out of rule enforcement reviews, it came out of ancillary investigation work done by [the Division of] Enforcement."

(c). CFTC commented on a footnote in our draft report which dealt with the stated purpose of the April-May 1980 review of the New York Mercantile Exchange's rule enforcement program. The purpose of the rule enforcement review, as set forth in the summary section of the staff's May 23, 1980, report, "was to determine whether the Exchange has a rule enforcement program and whether the program meets the minimum standards of compliance with Regulation 1.51." Our footnote characterized this question as "perplexing," since by 1980 CFTC had been in existence for more than 5 years and had already conducted two earlier rule enforcement reviews at the exchange as well as a review of the exchange's Regulation 1.51(a)(3) audit and financial surveillance subprogram (reported Feb. 20, 1980). This latter review disclosed several serious deficiencies and found the exchange to be in apparent violation of its self-regulatory responsibilities under the act.

CFTC stated that a May 12, 1980, memorandum from the Division of Trading and Markets to the Commission answers our questions by stating that the purpose of the Trading and Markets Division's review was to provide the Division with current information on the self-regulatory performance of the exchange. CFTC stated further that the May 12, 1980, memorandum states clearly that its review was initiated specifically in light of the Division of Enforcement's investigation, which by then had confirmed serious violations of the act by exchange members in two contracts traded on the exchange and in response to the Division of Enforcement's questions as to whether the exchange ought to be designated as a contract market in any contract. CFTC stated that it was precisely the concerns expressed by the Division of Enforcement that led the Division of Trading and Markets to review whether the exchange had a basic self-regulatory program in place.

We have deleted the footnote in question. It is not an essential part of our discussion. The essential point of our discussion is what we consider to be the inappropriately limited scope, depth, and duration of the April 30-May 2, 1980, New York Mercantile Exchange review and the overreaching, if not unfounded and erroneous, conclusions of that review as they related to the overall effectiveness of the exchange's compliance program at that time. Our reasons for concluding that a more thorough, comprehensive, and probing review of the exchange's compliance program was in order and that such a review would in all probability have produced different conclusions than those reached in the May 23, 1980, staff report may be summarized as follows:

(1) The nature of the alleged violations revealed in the Division of Enforcement's investigation of the New York Mercantile Exchange strongly suggested the possibility of serious problems with respect to the exchange's basic programs for, among other things, monitoring trade practice abuses, conducting investigations of alleged or apparent violations, taking prompt and effective disciplinary action against rule violators, and keeping full, complete, and systematic records which clearly set forth all actions taken as part of and as a result of its compliance program.

(2) Two earlier rule enforcement reviews at the New York Mercantile Exchange had disclosed serious deficiencies regarding several important Regulation 1.51 subprograms, including procedures for taking disciplinary actions, recordkeeping, investigation of alleged or apparent violations, and other surveillance, record examination, and investigation. In addition, a February 15, 1980, report on a review of the exchange's Regulation 1.51 (a)(3) subprogram for audits and financial surveillance of member firms had found the exchange to be in apparent violation of Regulations 1.51 and 1.52 under the act.

The second rule enforcement review of the exchange, reported on June 6, 1978, noted a need for greater involvement of exchange members in the analytical phases of market surveillance and the development of "an inquiring, decisive compliance staff." The review found the extent and quality of membership participation in compliance matters to be limited. There was minimal participation in market surveillance and "members did not appear totally committed to discharging their disciplinary function." Exchange procedures for taking disciplinary action were found to be "neither prompt nor effective."

These are the kinds of factors which are central to the effectiveness of an exchange self-regulatory program and which figured prominently in the Division of Enforcement's investigation into alleged trading abuses at the New York Mercantile

Exchange. Nevertheless, these factors received scant, if any, examination in the course of the third (April-May 1980) exchange rule enforcement review, despite the Trading and Markets Division's August 1978 letter to the exchange which stated that the exchange is expected "to make significant strides toward more active involvement by members in all phases of Exchange government." The August letter also stated that "the next rule enforcement investigation must find" such evidence of greater involvement of exchange members.

(3) In June 1977 CFTC instituted the first of two administrative proceedings against the exchange, alleging that the exchange had failed to exercise due diligence in enforcing certain of its rules incident to the 1976 potato default. This enforcement proceeding was terminated in October 1978 pursuant to an offer of settlement by the exchange. The exchange agreed to the payment of a $50,000 civil money penalty and an order to cease and desist from any failure to enforce its rules. We believe that this enforcement action and the circumstances underlying it constituted sufficient reasons in themselves for a more thorough, indepth examination of the exchange's compliance program in the course of the third exchange rule enforcement review.

(4) One CFTC commissioner told us in October 1981 that CFTC's handling of rule enforcement matters at the New York Mercantile Exchange had represented a series of "zig zags" and that he believed the 1980 rule enforcement review should have concluded and reported that the exchange's compliance program was inadequate. He characterized the exchange's compliance program at the time of the 1980 review as meriting a failing grade from CFTC.

(5) Perhaps the most telling evidence and compelling argument for our conclusion that the Trading and Markets Division should have conducted a more thorough, comprehensive, and evaluative review of the New York Mercantile Exchange's rule enforcement program in 1980 and in support of our belief that such a review would have produced markedly different conclusions concerning the effectiveness of the exchange's self-regulatory activities comes from the December 1, 1981, report of the exchange's compliance review committee. This committee, as part of the offer of settlement agreed to by the exchange on July 20, 1981, was assigned the task of reviewing and assessing the policies, practices, and procedures followed by the exchange in conducting its compliance program. The committee was also charged with pointing out weaknesses, if any, in the exchange's program and making recommendations for their correction.

Reporting in December 1981 (over 1-1/2 years after CFTC's third exchange rule enforcement review), the compliance review committee concluded that "it is apparent that the Exchange's pre-1981 compliance program contained serious deficiencies." [Emphasis provided.] Commenting upon steps taken by the exchange to improve its compliance program, the report stated that "while these represent major improvements, deficiencies remain."

(d). CFTC stated that our discussion leaves the impression that the focus of both the Division of Trading and Markets and the Division of Enforcement inquiries into exchange compliance activities was the same period when, in fact, the target periods covered by the two divisions' reviews were not the same. CFTC stated that this difference in target periods amounts to 1 year and that in this 1-year interval the May 23, 1980, staff report of the Trading and Markets Division shows that the exchange had made notable improvements in its compliance program. CFTC added that while neither the May 23, 1980, report or the Trading and Markets Division's May 12, 1980, memorandum to the Commission indicated in any way complete satisfaction with the exchange's compliance program, it was nevertheless clear that significant changes in that program had been made between the time the Division of Enforcement was investigating and the time (April 30-May 2, 1980) when the Trading and Markets Division conducted its review of the exchange's rule enforcement program.

Our dicussion clearly indicates the time periods covered by the Trading and Markets and Enforcement Divisions' reviews. This information is provided not only in chapter 7 but also in appendix XIII, which presents a chronological listing of CFTC rule enforcement reviews. We did not intend to mislead concerning the target periods of the respective reviews and, moreover, we believe that no false impression is conveyed or could result from a reasonably careful reading of our report.

Ordinarily, a matter of differing target periods would be an important factor to explore in trying to account for differing conclusions reached by separate investigations of the same general subject. However, we believe that this factor is not particularly relevant in the case of the inquiries conducted at the New York Mercantile Exchange by CFTC's Divisions of Enforcement and Trading and Markets. Our reasons for concluding this and for believing that a rule enforcement review conducted in a comprehensive and indepth manner in April-May 1980 would have produced markedly different conclusions 1/ than those reached by Trading and Markets Division staff are as follows:

(1) Although the Enforcement Division investigation was focused on trading in only two contracts (400-ounce gold and silver coins), the Enforcement Division investigators could not help but become aware of what appeared to be pervasive deficiencies in

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1/The May 23, 1980, staff report concluded that the New York Mercantile Exchange compliance program met "acceptable minimum standards" requiring "no further action at this time."

the exchange's rule enforcement program. It was for this reason, as we note in our discussion, and as CFTC acknowledged, that the division questioned the economic purpose and/or public interest in the continued designation of the exchange as a contract market in any commodity. The Enforcement Division's concerns reflected an understanding that (with minor exceptions that relate to unique aspects of particular commodities) rule enforcement is a general process that relates to the trading of all commodities on the exchange. There is no separate compliance staff for a gold contract or a silver contract; the same staff covers all contracts. The same is true of compliance procedures (for example, market surveillance, trade practice surveillance, investigations, recordkeeping, and disciplinary procedures). These too are generalized, for the most part, rather than commodity specific. As a result, insufficient staff, inadequately trained staff, and deficient procedures have across-the-board implications. An essential thrust of our discussion of the 1980 exchange rule enforcement review is that the Trading and Markets Division should have been guided by what the Enforcement Division had found and concluded regarding the exchange's compliance program.

(2) As discussed above, the New York Mercantile Exchange compliance review committee, established as part of the settlement of CFTC's enforcement action against the exchange, reported in December 1981 on its assessment of the exchange's compliance program. The committee's report concluded that, based on its study of CFTC reports, exchange documents and files, and interviews with knowledgeable persons, "it is apparent that the Exchange's pre-1981 compliance program contained serious deficiencies." [Emphasis provided.] The most notable of the deficiencies found to exist in the pre-1981 period were:

a. Investigative files and control logs were incomplete, frequently poorly documented, and inadequately maintained. Many cases were not numbered systematically and could not be located. Alleged violations were not explained fully and some do not appear to have been investigated in depth.

b. The compliance staff did not appear to search out and develop cases, especially long-term patterns and trading practices cases.

c. Member inspections, for the most part, were limited to financial and margin audits.

d. The compliance department did not have sufficient investigative and auditing staff to carry out an effective compliance and audit program.

e. The disciplinary procedures at the business conduct committee and adjudication levels were inadequate. Minutes are incomplete and committee findings were not explained sufficiently.

The committee's report acknowledged recent improvements in the exchange's compliance activity. It detailed substantial changes in the size and effectiveness of the compliance staff. It also stated that while these represent major improvements, deficiencies remain.

The final section of the committee's report set forth its views of the requisites for a more effective compliance program at the exchange, together with its specific recommendations. The following is an example of an area identified as needing improvement:

> "[the New York Mercantile Exchange's] rules relating to offenses and penalties are so general and vague as to be of little value in providing guidance to the Exchange's Compliance Staff, the Business Conduct and Adjudication Committees, the Board of Governors, and the members. Moreover, the Committee's review revealed some confusion and uncertainty among these parties concerning offenses and penalties, and particularly whether certain conduct constituted an offense and whether a particular sanction was an appropriate penalty. [the exchange's] pre-1981 failure to prosecute and the high percentage of case dismissals in prior years underscore this condition." [Emphasis provided.]

(3) During our audit we met with and discussed the exchange's compliance program with the individual who was hired by the exchange in April 1981 to head up its compliance program. This individual was formerly a senior enforcement attorney in CFTC's New York regional office. He acknowledged weaknesses in the exchange's compliance program at the time of CFTC's 1980 rule enforcement review and expressed puzzlement at how the program could have been found to be in minimal compliance with CFTC requirements. In addition to discussing inadequacies relating to the size and qualifications of staff, he noted problems with respect to trade practice investigations, other investigations, and adjudications.

(4) During our audit we met several times with the Director of CFTC's Division of Enforcement and discussed with him both the enforcement action against the exchange and the 1980 rule enforcement review of the exchange. On the subject of the 1980 compliance review, the Director stated that its language was "rhapsodic" in parts and its findings were "not supported by any evidence." He said that he had tried to minimize the significance of this rule enforcement review in relation to his division's own investigation, citing it only in a footnote and portraying it as "a limited purpose review of the exchange's potato contract." He felt that the report was "expansive in its language and would have been used against us."

2(e). CFTC stated that our conclusion that the Divisions of Trading and Markets and Enforcement made contradictory findings concerning the New York Mercantile Exchange rule enforcement program is erroneous. CFTC noted that a May 12, 1980, memorandum from the Division of Trading and Markets to the Commission discussed the limited nature of the Trading and Markets Division's review and acknowledged the possibility that the Division of Enforcement would find serious violations during the time period it reviewed. CFTC noted also that the memorandum in question discussed pending proposed rule changes pertaining to the exchange's round white potato futures contract and concluded that there was a significant public interest in seeing improvements to the potato contract. The memorandum concluded that

> "[e]ven if the Exchange's compliance program were found to be inadequate, the Division does not believe it would be appropriate for the Commission to defer approval of these amendments, since they effect changes in the contract which represent a distinct improvement in the contract and appear to serve a broader public interest in the proper functioning of the contract."

We note that the specific and overall conclusions reached in the May 23, 1980, report [1] are clearly at variance with findings made by CFTC's Division of Enforcement and with the report of the exchange's own compliance review committee. We also find these conclusions difficult to reconcile with the statements in the May 12, 1980, memorandum itself--such statements as: "* * * whatever conclusions the Division of Enforcement may reach with respect to the adequacy of the NYME compliance program * * *"; "Even if the Exchange's compliance program were found to be inadequate [by the Division of Enforcement] * * *"; and "The Division of Enforcement has identified serious violations of the Act by NYME members in * * * two contracts and on that basis, questions whether the NYME has a sufficient compliance program to retain its designation as a contract market in any futures contracts * * *."

Several comments are in order concerning the nature and purpose of the 1980 rule enforcement review of the exchange and the unusual handling of this review by the Division of Trading and Markets:

(1) CFTC has characterized this review as a very narrow and limited purpose review. Although we would certainly agree that the review was limited in scope and in depth, we have been provided with no evidence other than the May 12, 1980, memorandum

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[1] This staff rule enforcement review report was dated nearly 2 weeks after the memorandum referred to in CFTC's comment.

quoted by CFTC which characterizes the purpose of this review as being merely to facilitate Commission consideration of proposed rule changes in the exchange's potato contract. Nothing in the May 23, 1980, final report of the review indicates that its purpose and nature were viewed so narrowly. In fact, the purpose is stated quite expansively. In addition, CFTC has provided no documentation to indicate that, prior to this review, such a narrow purpose and limited mandate were intended and communicated to the New York regional office staff who actually performed the review. As noted previously, this review of the exchange had long been scheduled for execution in fiscal year 1980 and was contained in a list of projected reviews given to us in 1979, long before we began our audit work.

(2) The handling of the May 23, 1980, report of the exchange rule enforcement review was very unusual in that, as CFTC has acknowledged, the final report of this review was never formally transmitted to the Commission. According to information made available to us, this is the only rule enforcement review since at least the time of our 1978 review that has not been given formal Commission consideration. Several other rule enforcement reviews that also had limited purposes and involved limited expenditures of staff effort have been formally transmitted for Commission consideration. CFTC has provided no explanation for the unusual treatment accorded the May 23, 1980, report of the New York Mercantile Exchange rule enforcement review.

(3) A July 21, 1981, memorandum written by the Division of Trading and Markets expressed its concerns about NYME's compliance program and its reservations concerning the advisability of designating any additional contracts at the exchange. The division referred to its recent experience with NYME's surveillance and compliance programs which indicated that "the Exchange may not yet have established the willingness or determination to attain an adequate program of rule enforcement and trade practice surveillance." "In particular," the division's memo stated,

> "the adequacy of certain recent investigations conducted by the Exchange in response to referrals from the Division indicates that the Exchange may not yet have responded to deficiencies identified by the Commission's recent [enforcement] action and in the Division's latest rule enforcement review of NYME, presented to the Commission on June 6, 1978." [Emphasis supplied.] [1]

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[1] We are unable to account for the Trading and Markets Division's reference to its 1978 review of the New York Mercantile Exchange as its "latest rule enforcement review" of the exchange when this review was performed 2 years before the division's third (April 30-May 2, 1980) review.

To underscore, our basic point concerning the 1980 New York Mercantile Exchange rule enforcement review is that the scope and depth of this review were inappropriately limited in view of prior findings of inadequacy in selected aspects of the exchange's compliance program and, moreover, that the conclusions reached as a result of this review would in all probability have been different had the review been more thorough, probing, and intensive. As additional support for our view that a full-scale rule enforcement review of the exchange was in order, we would cite (in addition to our earlier discussion of two CFTC enforcement proceedings against the exchange and the findings of the exchange's own compliance review committee) additional information contained in the May 12, 1980, memorandum quoted by CFTC. This memorandum noted that the Division of Trading and Markets had recently completed a review of the exchange's Regulation 1.51 (a)(3) subprogram for audits and financial surveillance of member firms and had found that program to be seriously deficient. The division found that the exchange did not have adequate enforcement procedures, did not adequately document its work, conducted no surprise audits of member firms, and had no system to monitor the effects on member firms of price movements on other exchanges. The February 15, 1980, report concluded that "the Exchange appears to be in violation of regulations 1.51 and 1.52" and that enforcement action would be appropriate if prompt action were not taken by the exchange to correct the deficiencies.

CFTC's major point number 3

CFTC stated that, following our 1978 report, the focus of rule enforcement reviews shifted from broad-based reviews of each exchange's compliance program to more narrow inquiries directed at specific aspects of these programs. CFTC stated that this changed approach recognizes the difficulty of gaining an indepth understanding of an exchange's compliance program when attempting to review the entire breadth of such a program. It also allows the Trading and Markets Division to target its rule enforcement resources at specific aspects of exchange programs it believes may be deficient.

We support, in general, the focused approach to rule enforcement reviews which CFTC maintains that it has adopted. Such an approach, which focuses on specific areas of demonstrated or suspected weakness in an exchange's compliance program, represents an appropriate and efficient use of limited resources. Indeed, one of the recommendations we make is that the Commission place greater emphasis on reviews that cover carefully selected aspects of exchange activities but only after a period of comprehensive reviews has established that exchanges have effectively functioning self-regulatory programs in place.

We do not believe that the record of CFTC's rule enforcement review program or the documentation of exchange self-regulation accumulated to date supports a general shift at this time from broad-based rule enforcement reviews to narrow or limited scope reviews. Our analysis of the findings of rule enforcement reviews done to date, as well as statements made by the Director, Division of Trading and Markets, that most exchanges, under CFTC prodding, have only recently put in place basic self-regulatory machinery, support, we believe, our position that comprehensive rule enforcement reviews are still needed to assess how well exchange self-regulatory programs are functioning and to determine whether exchanges have in fact made a meaningful commitment to effective self-regulation.

In examining the rule enforcement reviews performed since our 1978 report was issued, we note that a narrow or focused approach has been employed by the Trading and Markets Division in several cases. We believe that these cases are fully recognized in our discussion and in related appendixes. However, as we also note in our discussion, we found that the number and frequency of rule enforcement reviews has not increased measurably as a result of the selective use of the narrowly focused approach. We also conclude that the approach has not been employed rationally and consistently. For example, as of the end of the second quarter of fiscal year 1982 CFTC had devoted 4,015 staff hours to a comprehensive rule enforcement review of the Chicago Mercantile Exchange, an exchange which it had in late 1977 praised as having the most effective compliance program examined up to that time. On the other hand, in its most recent review of the Chicago Board of Trade, the Division of Trading and Markets limited its review to only two of the eight subprograms listed under Regulation 1.51, despite the fact that in the prior review of the exchange's compliance program, serious deficiencies were noted in three additional areas of exchange self-regulatory responsiblity.

In its general comment #3, CFTC stated further that the two Regulation 1.51 subprograms selected for examination in the Chicago Board of Trade rule enforcement review--market surveillance and trade practice surveillance--are the two most significant subprograms and that other subprograms are largely derivative from or dependent on successful exchange implementation of these subprograms. Although we would not dispute the importance of these two basic surveillance activities, we cannot agree that they are somehow more important than other Regulation 1.51 subprograms. While it is true, for example, that surveillance programs can and should generate the basic data needed to protect market integrity and to police floor trading activity, such data would be without value in the absence of (1) effective procedures for conducting investigations, (2) complete and accurate recordkeeping and documentation, and (3) credible and effective procedures for taking disciplinary actions against exchange rule violators. If we were to single out any one element as being of decisive importance in determining the quality of an exchange's compliance program it would be the Regulation 1.51 (a)(7) subprogram relating to disciplinary actions. In our view, and in the view of others interviewed in the course of our audit work, this subprogram constitutes the crux of exchange self-regulation. It is the quality and effectiveness of exchange procedures for imposing sanctions against rule violators which demonstrates an exchange's commitment to self-regulation and the seriousness which it attaches to enforcing its rules and deterring rule violations.

According to the Director of CFTC's Division of Enforcement, the review of an exchange's enforcement record (that is, investigation and analysis of disciplinary cases and sanctions imposed in relation to the seriousness of rule violations alleged) is the most important aspect of a rule enforcement review. "This is where the key and the heart of the difficulties of self-regulation are" he told us. Similarly, the members of the New York Mercantile Exchange compliance review committee noted in their December 1, 1981, report that "the single most important consideration in providing effective compliance within an exchange is the development of a state of mind within the membership that violation of proper trading practices simply will not be condoned."

Our review of the findings of the Division of Trading and Markets' 1977-78 review of the Chicago Board of Trade's compliance program, which found serious deficiencies in the exchange's procedures for taking disciplinary actions [1.51(a)(7)] and in its recordkeeping [1.51(b)], coupled with Trading and Markets Division officials' expressions of skepticism concerning the quality and thoroughness of the prior Board of Trade rule enforcement review, strengthened our belief that a review confined to an examination of only two of the exchange's Regulation 1.51 subprograms was inappropriately limited in scope.

We questioned senior officials of the Division of Trading and Markets in late 1981 concerning the reasons for not including a review of exchange procedures for taking disciplinary actions within the scope of the rule enforcement review. We were told that the division did not have enough staff resources and wanted to keep the review limited so that it could be done quickly. As we note in our discussion and as CFTC has acknowledged in its comments, the review was not done quickly. When the review was finally reported to the Commission on April 20, 1982, it had consumed 21 months and over 5,598 staff hours.

CFTC's major point number 4

In commenting on our discussion of the amount of time which was allowed to pass between the first and second rule enforcement reviews of the Chicago Board of Trade and the Chicago Mercantile Exchange, CFTC acknowledged that "a significant period of time has elapsed" between reviews and that the completion of the second review "has extended over a considerable length of time." CFTC gave several explanations for this, including (1) the complexity and magnitude of even limited scope rule enforcement reviews, (2) limited staff, whose duties extend beyond performing compliance reviews, and (3) intervening events which caused "substantial diversions of available resources from the conduct of ongoing rule enforcement reviews."

We are aware of and acknowledge in our discussion the time and effort needed to conduct indepth rule enforcement reviews such as those performed most recently at the Chicago Board of Trade and at the Chicago Mercantile Exchange. At the same time, we cannot fail to note that the Division of Trading and Markets has itself taken the position that, to be most useful to the Commission, rule enforcement reviews should be completed and reported as quickly as possible. Timely completion of rule enforcement reviews (and the resultant ability to carry out more frequent reviews) was in fact the principal justification advanced by the Director of the Division of Trading and Markets for adopting a more limited and narrowly focused approach to performing these reviews.

Moreover, Trading and Markets Division officials intended and expected to be able to complete and report the Chicago Board of Trade and Chicago Mercantile Exchange reviews quickly. As we note in our discussion, the scope of the Board of Trade review was deliberately limited to only two of the eight Regulation 1.51 subprograms in order to permit quick completion of the review. For the Chicago Mercantile Exchange, a relatively comprehensive review of the exchange's Regulation 1.51 subprograms was believed by division staff to be susceptible to quick completion because of the overall high quality of the exchange's compliance program noted in the last (1977) CFTC review.

Our review disclosed that draft reports of the Chicago Board of Trade and Chicago Mercantile Exchange reviews were available, respectively, as early as March and April 1981. We reviewed a draft report of the Chicago Board of Trade review in July 1981 and of the Chicago Mercantile Exchange review in October 1981. Nevertheless, as of the end of the second quarter of fiscal year 1982 (Mar. 31, 1982), neither of these review reports had been formally presented to the Commission. The review of the Chicago Board of Trade's rule enforcement program was finally reported to the Commission on April 20, 1982. The review of the Chicago Mercantile Exchange's compliance program was reported on May 25, 1982.

CFTC stated that "a number of intervening events have caused substantial diversions of available resources from the conduct of ongoing rule enforcement reviews." We agree that these factors are valid reasons for the most part. Some of the specific factors cited for this diversion of resources were (1) monitoring and analysis of the 1979-80 silver crisis and related investigations into allegations of conflict of interest on the part of exchange officials, (2) reviewing the proposed rule enforcement programs of two new exchanges applying for CFTC designation (the New York Futures Exchange and the New Orleans Commodity Exchange), and (3) reviewing the rule enforcement and disciplinary aspects of NFA's registration application. This latter activity alone was reported to have diverted approximately 2.5 staff years from the conduct of formal rule enforcement reviews.

These comments agree with statements made to us by officials of the Division of Trading and Markets. In addition to citing the factors mentioned above, they cited preparations for initiating a pilot program for exchange-traded options as taking away heavily from staff time available for conducting rule enforcement reviews. One of these officials--who also expressed basic agreement with our overall conclusions regarding the Commission's rule enforcement review program--told us that "the Commission has set our priorities. Our time is not our own."

We see this diversion of contract market resources away from rule enforcement reviews as a principal explanation for delays in completing and reporting rule enforcement reviews and for the infrequency with which these reviews are performed. We agree that the designation of new boards of trade, the registration of a title III industry self-regulatory association, and the approval of new futures contracts and other trading instruments are important activities. However, we believe that the resources required to undertake these activities should not be obtained at the expense of a program as vital to accomplishment of legislative and CFTC objectives as is the rule enforcement review program.

In its fiscal year 1983 budget request, the Commission has requested a modest increase ($131,000) for its contract markets program to hire two additional staff people. This should help insulate the rule enforcement review program from ad hoc demands for resource diversion and prevent new programs such as exchange options trading from adversely affecting rule enforcement review activity.

CFTC's major point number 5

CFTC stated that our conclusion that the Commission has "not yet found a way to keep current of exchange rule enforcement" implies--incorrectly in its view--that rule enforcement reviews are the only means by which it is possible to have an up-to-date understanding of an exchange's rule enforcement program. CFTC stated that, in fact, rule enforcement reviews are only one of several methods that can be used to keep track of such programs. Some of the other methods cited by CFTC included trade practice investigations, routine daily floor surveillance, reviews of exchange disciplinary notices and emergency actions, and review and approval of exchange rules, especially those relating to trading practices and disciplinary procedures.

CFTC offered as an example of how methods other than rule enforcement reviews can provide insight into the quality of exchange self-regulation, a July 21, 1981, memorandum from the Division of Trading and Markets to the Commission expressing concerns about the New York Mercantile Exchange's compliance program based on, among other things, the exchange's handling of four recent referrals made by the division. CFTC stated that we should correct the misimpression it believes is conveyed by our discussion, namely that current evaluations of exchange programs can be obtained solely through rule enforcement reviews.

It was not our intention to suggest that we view rule enforcement reviews as the sole means by which CFTC can or should monitor the effectiveness of exchange self-regulatory efforts. We agree with CFTC that trade practice investigations, routine market surveillance, routine surveillance of floor trading, referrals, and reviews of exchange disciplinary notices and emergency actions constitute invaluable--indeed, indispensable--methods for monitoring the effectiveness of exchange self-regulation on a continuing basis. However, at the present time we do not see these techniques as substitutes for periodic rule enforcement reviews because none of them provide what a rule enforcement review provides; namely, a comprehensive, systematic, and indepth analysis of an exchange's overall compliance program which serves as a measure of the exchange's commitment to effective self-regulation. In time, with the demonstration of fully effective exchange self-regulation, such ancillary evaluation techniques could replace broad scope rule enforcement reviews. However, as we note in our discussion, we do not believe that time has yet arrived.

Although CFTC refers to activities such as trade practice investigations, referrals, etc., as alternative ways to maintain an up-to-date understanding of an exchange's rule enforcement program, we have not seen any evidence that CFTC itself has placed significant reliance on these methods as substitutes for rule enforcement reviews. The portion of our discussion to which CFTC alluded in its comments deals with linking contract market designation to an exchange's performance of its self-regulatory responsibilities. The Division of Trading and Markets has in recent months instituted a procedure whereby it prepares for Commission consideration, in connection with deliberations on contract market designation applications, an "expanded Guideline II analysis" which attempts to characterize the overall quality of the applicant exchange's rule enforcement program. Our review of these Guideline II memorandums revealed that in virtually all cases the division has relied primarily, if not exclusively, on the findings of prior rule enforcement reviews. In some cases, these reviews had been made several years earlier.

For example, in the case of a Chicago Board of Trade application for designation as a contract market in 90-day domestic certificates of deposit, the division referred to its "most recent rule enforcement review of the [Board of Trade] presented to the Commission on January 31, 1978" and to the findings of that review. The memorandum made no reference to any ancillary techniques used by the division to keep abreast of the Board of Trade's compliance program. Similarly, in the case of an application by the Chicago Mercantile Exchange for designation as a contract market in plywood, the division in a June 15, 1981, Guideline II memorandum referred to its "latest rule enforcement review of the [Chicago Mercantile Exchange], presented to the Commission on August 8, 1977" and to the preliminary findings of its second, ongoing review of the exchange. Again, no mention was made of any alternative techniques used to evaluate the quality and effectiveness of the exchange's rule enforcement program.

The July 21, 1981, memorandum to which CFTC refers in its comment is itself an example of an "expanded Guideline II memorandum." This memorandum was submitted to the Commission by the Trading and Markets Division in connection with the New York Mercantile Exchange's application as a contract market to trade futures contracts in Gulf Coast No. 2 heating oil. We find this sole, specific example of "alternative methods" offered by CFTC a weak one because the memorandum in question devoted far more attention to the July 20, 1981, enforcement settlement with the exchange and to CFTC's second (June 6, 1978) rule enforcement review of the exchange than it did to "alternative methods." The memorandum's discussion of alternative methods is limited to a brief mention of "four recent referrals" to the New York Mercantile Exchange, the exchange's handling of which indicated to the division that the exchange "may not yet have responded to deficiencies identified by" the July 20, 1981, enforcement action and by the 1978 rule enforcement review.

CFTC's specific point number 1

CFTC stated that while chapter 7 of our draft report noted at one point that "significant improvements" had been made in the rule enforcement review program, such an assessment is not made in the introduction or conclusion to the chapter. We have made minor changes to the text of chapter 7 that reflect our overall assessment that while some improvements have been made since our 1978 review, a number of additional improvements are needed.

CFTC's specific point number 2

CFTC stated that while we discuss improvements to the rule enforcement review program proposed by the then Director of the Division of Trading and Markets in a March 20, 1979, memorandum to the Commission, it is incorrect to state, as we do, that only some of the proposed improvements have been adopted. CFTC stated that all of the improvements proposed in the memorandum have since been incorporated into the rule enforcement review program, including reviewing the exchange's original source material and reviewing areas not investigated by the exchanges themselves.

Our statement that "some of the improvements" proposed in the March 20, 1979, memorandum have been adopted reflects the fact that one of the more significant proposals made by the Division Director has not been implemented by the Trading and Markets Division. This proposal dealt with the use of Regulation 1.50 "special calls" (special requests for information) to obtain periodically from exchanges descriptive and factual information concerning the form, organization, and operation of their rule enforcement programs. As the Director's March 20, 1979, memorandum pointed out, the modified rule enforcement review program which he was proposing called for a periodic division report to the Commission concerning each exchange's rule enforcement program. The reports would reflect both "input" and "output" considerations. The input-type information--the descriptive and factual information referred to above--would be obtained from the exchanges pursuant to a Regulation 1.50 special call. Such a call would be designed to provide the Commission with verifiable data relating to Regulation 1.51 responsibilities which could be spot audited by CFTC for accuracy. The output element, the second component of the proposed program, would be designed to determine whether or not the rules and statutory obligations are in fact being carried out. This element would be essentially analytical and evaluative in nature and would be carried out by Trading and Markets Division staff.

The benefits that were foreseen as a result of adopting the proposed approach included: (1) greater specificity, which would help the Commission determine whether the rules and requirements are in fact being carried out and, in the event they are not, provide a clear basis for making a determination regarding enforcement action, (2) allowing for reviews on an annual or regular basis, thus providing better followup to determine whether the exchange has in fact corrected previously noted deficiencies and (3) allowing for better use of regional resources.

During the course of our audit, Trading and Markets Division officials told us that they had not implemented the Regulation 1.50 special call feature proposed in the March 20, 1979, memorandum and that they have never used the 1.50 call provision to obtain from exchanges current information regarding the organization and operation of their compliance programs. As we discussed, the division has also been unable to achieve the annual or regular review of exchange programs which was an expected benefit of the modifications proposed in the March 20, 1979, memorandum.

CFTC's specific point number 3

CFTC disagreed with our analysis of followup on rule enforcement reviews, particularly our statement that Trading and Markets Division staff have not promptly and effectively followed up to ensure exchange implementation of corrective measures recommended by CFTC. According to CFTC, our discussion of this subject ignores documentation which was provided to us that shows that CFTC staff "diligently has followed-up on recent reviews." Specifically cited are staff followup activities in connection with the MidAmerica Commodity Exchange and the Coffee, Sugar and Cocoa Exchange.

Our statements concerning the lack of prompt and effective followup on rule enforcement review findings and recommendations were based on our analysis of CFTC procedures for monitoring and assessing exchange actions to promptly correct deficiencies revealed in the course of rule enforcement reviews. In reviewing reports of successive rule enforcement reviews, typically performed at intervals of 2, 3 or 4 years, we found a fairly consistent practice of characterizing subsequent rule enforcement reviews at a given exchange as "follow-up reviews" to determine whether and to what extent the exchange had implemented CFTC's recommendations and corrected previously noted weaknesses in its compliance program. We found that in some instances a subsequent rule enforcement review disclosed a persistence of previously noted problems and that the exchange in question obviously had not taken appropriate and/or sufficient action to remedy the problems in the intervening period.

An example of a rule enforcement review which was essentially a followup review to verify and assess corrective actions taken is provided by the September 16, 1981, report on the Commodity Exchange, Inc. At the time of our audit work this was the most recent rule enforcement review to have been reported to the Commission by the Division of Trading and Markets. The introduction to the rule enforcement review report states that in addition to examining exchange emergency actions relating to silver trading, the report consists of "an analysis of the Exchange's implementation of corrective measures in response to the division's previous rule enforcement review presented to the Commission on July 16, 1979."

A major section of the report (26 pages) is entitled "Implementation of Recommendations from Previous Rule Enforcement Review." This section makes repeated references to the Trading and Markets Division's findings concerning whether the exchange had implemented CFTC recommendations made as a result of the 1979 rule enforcement review. In at least two important instances, the division found that problems discovered in the earlier review remained uncorrected 2 years later.

The Commodity Exchange, Inc., rule enforcement review is revealing for what it says about the nature of CFTC followup between rule enforcement reviews. As we discussed, such followup as there is generally consists of requiring an exchange to report in writing to CFTC on the action it has taken or plans to take to implement the agency's recommendations. We reported that CFTC verification of the corrective action and of its effectiveness must generally await the next rule enforcement review--often a delay of 2-4 years.

In connection with the exchange's Regulation 1.51(a)(4) subprogram for handling customer complaints, the September 16, 1981, report recaps the principal recommendations CFTC made as a result of its 1979 review. The report then notes that the exchange, in its January 28, 1980, response to CFTC, stated that it had implemented the recommendations. The report goes on to state that the Division of Trading and Markets undertook "to verify" the exchange's response in the latest rule enforcement review and found the situation to be essentially "as represented" by the exchange [emphasis supplied]. On the other hand, in connection with the exchange's Regulation 1.51(a)(6) subprogram for "other examinations and investigations," the report noted that "the Division found, as it did in its 1979 Review, that many of the special studies were not completed on a timely basis." As a result, the 1981 report repeated the recommendations made to the exchange in 1979 that:

> "All special studies and similar investigations must be completed on a timely basis and reviewed to determine whether corrective action is needed."

Other recent rule enforcement reviews which have been characterized by CFTC as followup rule enforcement reviews and/or which make extensive reference to prior rule enforcement reviews and to their findings and recommendations are (1) the February 17, 1981, report on the Coffee, Sugar, and Cocoa Exchange, Inc., and (2) the February 13, 1980, report on the New York Cotton Exchange. In addition, draft reports on the most recent reviews of the Chicago Board of Trade and Chicago Mercantile Exchange compliance programs, provided to us by CFTC in October 1981, characterized these rule enforcement reviews as followups on the prior reports on Chicago Board of Trade (1/23/78) and Chicago Mercantile Exchange (8/8/77) and referred extensively to the findings and recommendations of the earlier reports. However, in the case of the final version of the Chicago Board of Trade report, presented to the Commission on April 20, 1982 (that is, after CFTC had an opportunity to review our draft report), the rule enforcement review was no longer characterized as a followup review and previously extensive references to the findings and recommendations of the earlier review had largely been deleted.

CFTC cited work done at the Coffee, Sugar, and Cocoa Exchange, Inc., and at the MidAmerica Commodity Exchange as illustrative of the timely and substantive nature of followup performed in connection with recent rule enforcement reviews. It is important to put this work in perspective and to make clear that it represents the exception to Trading and Markets Division's standard operating procedures rather than the rule. For example, CFTC records show the followup work to assess the new computer surveillance system of the Coffee, Sugar and Cocoa Exchange, Inc., was not done on the division's initiative but rather at the specific request of one Comissioner who, at the February 24, 1981, meeting at which the division presented its rule enforcement report on the Coffee, Sugar, and Cocoa Exchange, Inc., asked for a report on the computer surveillance system when it became operational. The October 14, 1981, report was in response to this request.

The followup work at MidAmerica Commodity Exchange represents, in a similar manner, something of a special case. This case is exceptional because of a CFTC enforcement action brought against the exchange in 1977 and because of longstanding concerns related to the exchange's changer rules. As part of an August 16, 1977, settlement with CFTC, the exchange entered into an undertaking which involved periodic reporting to CFTC on the steps it had taken to comply with the terms of the settlement. Much of the correspondence to which CFTC refers deals with continuing CFTC concerns regarding matters dealt with in the 1977 undertaking.

A very recent example of a rule enforcement review designed to assess corrective actions recommended as a result of an earlier review is the May 7, 1982, report of the Trading and Markets Division on its review of NYME's Regulation 1.51(a)(3) audit and financial surveillance subprogram. This report is specifically designated by the division as a "followup" on its initial review of the exchange's subprogram performed in late 1979 and early 1980 which disclosed very significant deficiencies in the subprogram amounting to what appeared to be violations of Regulations 1.51 and 1.52. Trading and Markets Division documents make it clear that the subsequent review was made to determine the adequacy of action taken by the exchange to correct deficiencies disclosed in the division's initial review 1-1/2 years earlier.

CFTC's specific point number 4

CFTC stated that our discussion of its most recent rule enforcement review of the Chicago Board of Trade fails to note that the two Regulation 1.51 subprograms dealt with in the review are the two most important for an effective rule enforcement program and the two in which CFTC found the exchange to be most deficient in its first (1978) review of the exchange. This comment essentially duplicates part of CFTC's general comment number 3 to which we have responded fully.

CFTC's specific point number 5

CFTC stated that our analysis of staff years devoted to rule enforcement reviews in fiscal years 1980, 1981, and 1982 failed to include staff time spent on examinations of the rule enforcement programs of the New York Futures Exchange, the New Orleans Commodity Exchange, or NFA.

We did not include staff time devoted to these examinations in our overall statistics relating to rule enforcement reviews, because these were not, strictly speaking, rule enforcement reviews. Rather, as we note in appendix XIII, these were examinations of the proposed rule enforcement programs of entities not yet approved by CFTC and not yet in operation. In recognition of this important difference, CFTC itself assigns a different accounting code to this review activity than it does to reviews of operational self-regulatory programs.

In making this distinction, it is not our intention to minimize the importance of evaluations of the proposed rule enforcement programs of boards of trade or industry self-regulatory associations applying for Commission designation. Nor is it our intention to ignore the fact that it has generally been the same staff within the Division of Trading and Markets who are called upon to perform both kinds of analysis. In fact, Trading and Markets Division staff told us that one of the reasons they had been able to spend less time than they might have preferred on rule enforcement reviews was the need to review the applications and proposed rules, organization, and procedures of new exchanges and the new title III industry self-regulatory association (NFA). We believe that in view of the importance of both of these activities, sufficient resources should be earmarked to them to obviate the need for either to be performed at the expense of the other.

CFTC's specific point number 6

CFTC stated that our presentation and discussion of the Trading and Markets Division's fiscal year 1980 plan for conducting rule enforcement reviews does not adequately reflect the various reasons for delays and slippage in carrying out the plan. Specifically, CFTC noted that while a rule enforcement review of the New York Futures Exchange was planned to be completed by September 30, 1980, the exchange did not begin trading until August 7, 1980. More generally, CFTC refers to a number of "intervening events" which necessitated adjustments to the division's plans. Elsewhere in the agency's comments, these intervening events are identified as involvement in monitoring and investigating the 1979-80 silver situation and reviewing the initial designation applications of the New York Futures Exchange, the New Orleans Commodity Exchange, and NFA.

We fully agree with what we believe to be the thrust of the agency's comments; namely, that any plan will be subject to adjustment and revision based on subsequent experience and unforeseeable contingencies. We do not, of course, mean to criticize Trading and Markets Division staff for failing to complete a rule enforcement review at the New York Futures Exchange by September 30, 1980, when trading did not begin on that exchange until August 7, 1980. Accordingly, we have added a footnote to the plan presented on page 110 making it clear that the exchange was not designated as a board of trade until July 15, 1980, and did not begin trading until nearly a month later.

As for CFTC's reference to "intervening events," we appreciate that any plan must be sufficiently flexible to accommodate changed priorities and unforeseen needs. Nevertheless, we underscore our view that the rule enforcement review activity is an extremely important one and one which should be insulated from the vicissitudes of daily operations and from *ad hoc* regulatory concerns. It is important, in our opinion, to maintain the continuity and momentum of rule enforcement reviews as a means of providing comprehensive oversight of exchange self-regulation and of continuously upgrading self-regulation over time.

CFTC's specific point number 7

CFTC commented that a statement attributed by us to an Assistant Director of the Trading and Markets Division concerning the division's plans for fiscal year 1982 rule enforcement reviews was not totally accurate. CFTC stated that although the Assistant Director acknowledged that not all of the projected eight fiscal year 1982 reviews had been identified, he did not state or mean to suggest that none of them had been. CFTC cited as evidence of this our own discussion of the division's review of the New York Futures Exchange, begun in November 1981 (that is, in early fiscal year 1982). CFTC also stated that as of the date of its comments (Mar. 8, 1982) reviews of the New York Cotton Exchange and the Kansas City Board of Trade were in the preparatory stages.

We believe that CFTC has misconstrued our statement concerning the projected fiscal year 1982 rule enforcement review schedule. First, we do not characterize the Assistant Director's statement as implying that "no exchanges" had been selected. Our own discussion of the New York Futures Exchange rule enforcement review (on the previous page) makes it clear that this could not have been our intention. Second, and more important, the point of our discussion has to do with the fact that in early January 1982, more than one quarter into fiscal year 1982, the identification of exchanges to be reviewed in that period had not been completed. Indeed, as of March 8, 1982, the date of CFTC's comments, CFTC had identified only three of the eight anticipated rule enforcement reviews. This fact relates directly to our discussion of the need for better planning, scoping, and scheduling of rule enforcement reviews and the need for greater Commission direction and suppport of the rule enforcement review program.

To preclude ambiguity or confusion, we have revised our discussion to indicate that as of January 6, 1982, the selection of exchanges for fiscal year 1982 rule enforcement reviews "had not yet been completed," rather than "had not yet been made."

CFTC's specific point number 8

CFTC commented that our statement that its rule enforcement procedures manual was finalized and adopted in late 1981 is inaccurate. CFTC stated that the procedures manual was in fact adopted in early 1981 and, moreover, that the manual merely formalized procedures which had been previously established.

Information available to us, including draft versions of the procedures manual in question and records of interviews with Trading and Markets Division officials in March and October 1981, indicates that a draft of the procedures manual had been sent to the Division Director for review and approved in March 1981 and that the manual was finalized and officially adopted in October 1981. However, since our information also shows that there were essentially no changes made to the procedures manual between March 1981 and October 1981, we believe there is no reason not to accept CFTC's assertion that the manual was finalized and adopted at the earlier date. Accordingly, we have amended our footnote to indicate that the guidelines were finalized and adopted in March 1981.

We also take note that CFTC stated in its July 14, 1978, response to our last report that its staff would, by the end of 1978, begin to draft procedural guidelines. These guidelines were not available for first use until the review of the New York Futures Exchange, begun in November 1981.

CFTC's specific point number 9

CFTC alluded in this specific comment to its earlier "major points" relating to our comparison of the 1980 New York Mercantile Exchange rule enforcement review and the contemporaneous Enforcement Division investigation into selected exchange rule enforcement activities. We responded fully to these earlier comments.

CFTC's specific point number 10

CFTC commented on our discussion of its regulations relating to time sequencing of exchange trades. CFTC stated that our discussion implied that opposition to 1-minute time sequencing emanated primarily from the larger commodity exchanges when, in fact, according to CFTC, "opposition to one-minute timing was expressed by virtually all exchanges." CFTC stated also that, as recommended by us in 1978, it did consider the feasibility of a system of 1-minute time sequencing of trades but ultimately decided not to require 1-minute timing out of a conviction that current technology was inadequate to implement such a requirement without risk of disrupting market activity.

We have amended our report to show that while several commodity exchanges demonstrated a willingness and ability to achieve the 1-minute time sequencing standard--and, as CFTC points out, three smaller exchanges currently use 1-minute timing--opposition to CFTC's rule 1.35(g)(1) was, nevertheless, widespread among exchanges.

EXCHANGE COMMENTS AND OUR EVALUATION 1/

Chicago Board of Trade

The exchange's comments concerned the quality and adequacy of its compliance program as evaluated by CFTC in its 1977-78 rule enforcement review of the exchange and as the program has developed in the intervening period. The exchange stated that our report implies that its compliance program has been consistently inadequate since CFTC's first rule enforcement review and described this implication as both untrue and unfair. The exchange stated that it has made substantial changes to its programs and procedures since the 1977-78 rule enforcement review and described some of these changes, which included: (1) adopting and implementing on August 17, 1981, disciplinary rules, (2) developing several computer programs designed to provide its enforcement staff with information which is easy to comprehend and interpret, (3) taking more initiative in investigating and developing evidence, and (4) more completely documenting investigative reports. The exchange stated that it could not comment on CFTC's most recent review of its compliance program because it had not yet seen CFTC's report. The exchange commented finally that the mere fact that a number of errors are mentioned in CFTC's rule enforcement review reports does not mean that the exchange's compliance program is generally inadequate. The exchange noted that "the degree of involvement by the public in our markets proves that our markets work and enjoy public confidence."

Although we refer in our discussion to CFTC's first Chicago Board of Trade rule enforcement review in 1977-78 and to some of the findings of that review, this early review is not the principal subject of our discussion. Our focus, rather, is on the length of time which CFTC allowed to pass before conducting a second rule enforcement review at the exchange and on the limited scope of the second review (only two of the eight Regulation 1.51 subprograms). As we note in our discussion and in our response to CFTC comments, we found the limited scope of this second review difficult to reconcile with the size and economic importance of the exchange's markets and with the number and seriousness of deficiencies highlighted in CFTC's first rule enforcement review.

We have no way of independently determining to what degree deficiencies reported by CFTC in its 1977-78 Chicago Board of Trade review have persisted, and in our discussion only relate the views of Trading and Markets Division officials on this point. We believe, and state in our discussion, that a more timely and comprehensive rule enforcement review of the Nation's largest commodity futures exchange would have provided CFTC with a clear

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1/The exchanges' comments are presented in their entirety in app. XVI.

indication of the extent to which problems identified by the earlier review persisted or had been rectified by the exchange.

At the time our draft report was provided to the Chicago Board of Trade and other interested parties for comment, the most recent CFTC rule enforcement review of the Chicago Board of Trade had not yet been presented to the Commission or discussed with the exchange. Our characterization of the findings of this review was based on a draft report made available to us by CFTC staff in October 1981. The review in question was finally reported to the Commission on April 20, 1982. The report found weaknesses in the exchange's subprogram for surveillance of market activity [1.51 (a)(1)] and more serious deficiencies in its subprogram for surveillance of trading practices [1.51(a)(2)].

Regarding market surveillance, the Commission's report concluded that the exchange's conduct of an affirmative action market surveillance program has been hampered by the exchange's limited conduct of daily surveillance of clearing member positions prior to expiration, particularly in consecutively expiring contracts, and by its reliance on CFTC to identify market positions of individual traders. Regarding the exchange's surveillance of trading practices, the report noted several deficiencies. CFTC stated that these weaknesses appear to be the result of inadequate investigatory procedures and utilizing of computer runs that "are not designed to permit an effective evaluation of trading data for recognition of trading abuses."

Chicago Mercantile Exchange

The exchange's comments dealt with our characterization of the findings of CFTC's most recent review of its rule enforcement program presented in appendix XIV of our draft report and with the system we employed in classifying CFTC's findings. The exchange stated that with respect to its compliance with the requirements of Regulation 1.51(b) dealing with recordkeeping and our characterization of CFTC's findings in this regard, it had never been informed of the "serious deficiencies" found by CFTC in its most recent rule enforcement review and was unaware of the reasons for this finding and hence unable to comment specifically. The exchange stated further that it did not have serious deficiencies in complying with recordkeeping requirements and was prepared to demonstrate the quality of its recordkeeping. Commenting on the classification system for CFTC rule enforcement review findings initially used by us, the exchange stated that the analysis was biased and unfair because under our scheme there is no category for a performance that might be "outstanding."

At the time our draft report was provided to CFTC and to other interested parties, including the Chicago Mercantile Exchange, for comment the most recent CFTC rule enforcement review of the exchange had not yet been presented to the Commission or discussed with the exchange. Our characterization of the findings of this review was based on our analysis of a draft report made available to us by CFTC in October 1981. The rule enforcement review in question was finally reported to the Commission on May 25, 1982, and the exchange was given an opportunity to review and comment on the report.

Although there were minor changes in CFTC's description of its findings with respect to the exchange's compliance with 1.51 (b) recordkeeping requirements between the October 1981 draft report and the final report, these findings remained essentially the same. The findings clearly pointed to a deficiency regarding the exchange's recordkeeping in connection with its market surveillance activities. In its conclusions and recommendations, CFTC stated that

> "the Exchange must maintain full, complete and systematic records with regard to all facets of its market surveillance program. In order to comply with regulation 1.51(b) it is incumbent on the Exchange to develop a system which results in documentation of the actions by the Market Surveillance staff, whenever surveillance of market activity is conducted."

Due to the potential for problems of ambiguity and subjective interpretation, we have revised our scheme for classifying CFTC findings of deficiencies in exchange self-regulatory programs so that there is no longer a separate category of "serious deficiencies." Thus, in appendix XIV we note simply that CFTC in its most recent rule enforcement review of the exchange found deficiencies regarding the exchange's 1.51(b) subprogram for recordkeeping. In response to the exchange's more general comment concerning "skewing" or "bias" in our appendix XIV classification scheme resulting from the omission of an "outstanding" category, we can only state that in our review of CFTC's rule enforcement reviews completed since 1978, we found no instance where an exchange's performance has been classified as outstanding. As a result, we saw no need to provide such a category in our classification scheme.

Coffee, Sugar, and Cocoa Exchange

The exchange's comments were primarily technical in nature and dealt with our characterization in appendix XIV of CFTC's successive reviews of the exchange's rule enforcement program and of their respective findings. The exchange suggested a slight change in our characterization of the findings of CFTC's most recent rule enforcement review as it related to surveillance of trading practices [1.51(a)(2)]. We have made this change to indicate that while CFTC found certain deficiencies in the exchange's performance of this activity, these deficiencies were not specifically characterized as serious by CFTC. CFTC's Division of Trading and Markets stated in its report on this rule enforcement review that it did "not believe the exchange was in compliance with Commission regulation 1.51 (a)(2) during the target period."

The exchange also suggested changes in the dates of CFTC rule enforcement reviews shown in appendix XIV. We have retained our original dates which relate to the dates shown on CFTC internal documents reflecting the first date of availability rather than the dates provided by the exchange which relate generally to the publication of these documents.

Commodity Exchange, Inc.

The exchange's comments dealt principally with our characterization in appendix XIV of the deficiencies in its rule enforcement program disclosed by successive CFTC rule enforcement reviews. The exchange objected to the use of the term "serious" regarding the description of the deficiencies found by CFTC, stating that CFTC itself had not used this term. The exchange also believed that we should take note of the fact that CFTC has stated that the exchange has shown steady progress in the performance of its self-regulatory responsibilities.

We have revised appendix XIV to indicate that while CFTC has noted various deficiencies in its recent Commodity Exchange, Inc., rule enforcement reviews, it has not specifically characterized these deficiencies as serious. Moreover, in its latest rule enforcement review of the exchange, CFTC found that the exchange was "generally in compliance with Commission regulation 1.51."

As we note in appendix XIV, CFTC's most recent review of the Commodity Exchange, Inc., rule enforcement program analyzed the exchange's implementation of corrective measures in response to the prior (1979) rule enforcement review and found that the exchange had implemented CFTC's recommendations to ensure continuous market surveillance [1.51 (a)(1)]. In connection with exchange surveillance of trading practices [1.51 (a)(2)], CFTC found that while the exchange had implemented its recommendation that it formulate and implement written guidelines for surveilling trading practices, exchange procedures for the systematic monitoring of certain classes of trades remained "insufficient" to detect possible abuses.

In the case of the exchange's subprogram for conducting other examinations and investigations [1.51 (a)(6)], CFTC found, as it did in its 1979 rule enforcement review, that many of the special studies were not completed promptly. As a result, CFTC restated the recommendation made as a result of its prior review that "all special studies and similar investigations must be completed on a timely basis, and reviewed to determine whether corrective action is needed." CFTC's finding in the 1979 Commodity

Exchange, Inc., rule enforcement review that the exchange was "not in compliance with this regulation" and its finding in its latest exchange rule enforcement review that the situation remained essentially unchanged constituted the basis for our initial characterization of this deficiency as serious, even though CFTC had not itself used this term.

Kansas City Board of Trade, Inc.

The exchange commented on the description and finding of CFTC's latest review of its rule enforcement program as presented in appendix XIV of our draft report. The exchange stated that the trading activities which gave rise to CFTC's review involved "one or at most two traders in a deferred month" and were deemed by the exchange to be of minor significance. The exchange stated that "far too much was being made of fairly unimportant events," but that, nevertheless, to the extent that CFTC had suggested changes, the exchange had implemented them. The exchange requested that our discussion be amended to state this and to note that the exchange denies that there were any substantial problems. Appendix XIV has been revised to reflect the exchange's comments.

New York Cotton Exchange

The exchange's comments related primarily to our characterization of the findings of CFTC's most recent rule enforcement review, specifically CFTC's findings with respect to exchange surveillance of trading practices [1.51 (a)(2)]. We have revised the relevant portion of appendix XIV to show that CFTC found this subprogram to be much improved over the situation disclosed in the prior (1978) rule enforcement review of the exchange and, as a result, in full compliance with CFTC requirements.

New York Mercantile Exchange

The exchange's comments dealt chiefly with our discussion of CFTC's most recent (Apr.-May 1980) review of its rule enforcement program and how we contrasted the findings of that review with CFTC's 1981 enforcement action against the exchange. The exchange stated that while the conclusions of the two CFTC investigations might appear to conflict. there are factors which can account for this apparent inconsistency. One factor cited by the exchange was the difference in time periods covered in the two CFTC investigations. The exchange stated also that our report appears to assume that the conclusions of the Division of Enforcement were right while those of the Division of Trading and Markets were wrong. Such an assumption, the exchange noted, may be incorrect. It added that while the Division of Enforcement made many allegations, none of those charges was ever tested in court or admitted by the exchange. In connection with our quoting of an exchange vice president on the quality of the exchange's compliance program in the April-May 1980 period, the exchange stated that it should be made clear that this individual was expressing his own opinions and not speaking on behalf of the exchange. In addition, the exchange stated its total disagreement with its vice president's conclusions regarding the Trading and Markets Division's May 1980 report and the quality of the exchange's compliance program at that time.

We believe that in our response to CFTC's comments on chapter 7 we have fully addressed the points raised by the New York Mercantile Exchange. Although we understand the position of the exchange in disassociating itself from statements made to us by its vice president, we do not believe that we can so readily disregard this assessment of the exchange's overall compliance program. We believe, moreover, as stated in our response to CFTC comments, that this assessment was essentially confirmed by the December 1, 1981, report of the exchange's own compliance review committee. This same report also points out that in recent months the exchange has taken important steps to increase the size and professional competence of its compliance staff and to enhance the quality of its self-regulatory program generally.

CHAPTER 8

REPARATIONS AND OTHER MEANS OF RESOLVING CUSTOMER CLAIMS ARE INADEQUATE

In 1974 the Congress amended the Commodity Exchange Act to establish a reparations program, an adjudicatory process to resolve disputes between commodity customers and industry professionals concerning such abuses as excessive or unauthorized trading and fraud. The objective of the new program was to provide an alternative grievance procedure, midway in complexity and expense between the industry's traditional remedy of arbitration and court litigation. We found that since our 1978 report, CFTC has significantly improved its complaint screening process which is an important segment of the program. However, CFTC's reparations program has not generally fulfilled its objectives. The reparations program continues to be lengthy relative to the available alternatives of arbitration and court litigation because the agency has limited resources to meet the growing number of complaints filed each year. In addition, the process is slow because the chief Administrative Law Judge (ALJ) (1) does not immediately assign complaints to presiding officers and (2) has not developed standards that would encourage the presiding officers to maintain high productivity. The reparations program is difficult for customers to use because CFTC rules and processes are complex. We also found that because the reparations process is difficult to understand and follow, complainants often consider it necessary to hire attorneys. As a result, the process is often expensive.

Due to limited time and resources and insufficient planning, CFTC does not collect enough management information that would enable (1) both CFTC and the Congress to evaluate the program, (2) the Congress to determine the future of the program, and (3) CFTC to inform the public how long a reparations procedure is likely to take.

PROGRAM OBJECTIVES--TO BE FAST, EASY, AND INEXPENSIVE

In an attempt to bring about inexpensive and expeditious adjudication of customer claims, the Congress in 1974 directed CFTC to establish a reparations procedure for adjudicating customer complaints against commodity professionals. In effect, the 1974 legislation envisioned a procedure analogous to the operation of a small claims court. When the Congress authorized the reparations program, other means for resolving customer complaints, court litigation, and various arbitration forums already existed. In establishing a reparations program, the Congress intended to create an expeditious, inexpensive, and easy-to-use dispute resolution process, available to as many commodity customers as possible.

Since the reparations program began, CFTC has reiterated the Congress' objectives. The stated purpose of changes made to the program to date has been to further refine the reparations process so it can be quick, easy to use, and inexpensive. In our 1978 report we found several problems in the program, including growing backlogs, overly complex procedures, and an absence of guidelines and productivity standards to help screen and adjudicate claims. Our present review disclosed that many of these problems still exist. Although CFTC has implemented all our recommendations on complaints screening, it needs to make some management improvements in certain aspects of the adjudication process so that (1) it can better handle the growing number of complaints received each year and (2) complainants can better understand the process.

HOW THE REPARATIONS PROGRAM WORKS 1/

Customers forward their complaints to CFTC's complaints section where the staff screens them. The staff initially screens each complaint to determine whether (1) the CFTC registrant(s) 2/ named in the complaint may have violated the act or a CFTC regulation and (2) the customer(s) may have suffered a loss as a result of this alleged or suspected violation. After the initial screening, the staff will either reject and return a complaint (if it appears the above criteria were not met) or notify the registrant(s) in question that a customer has filed a complaint against it. In the latter case, the registrant must respond to the allegations within 45 days. After the section receives the registrant's response, the staff will determine whether to reject and return the complaint or, if it appears to have merit, to transfer it to the hearings section, where a presiding officer (either an ALJ or hearing officer 3/) will render a decision.

The hearings section divides the complaints it receives into three categories--defaults, complaints involving claims of $5,000 or less, and complaints involving claims in excess of $5,000.

1/The information in this section of the chapter is based primarily upon our review of program regulations and interviews with CFTC officials.

2/Persons or firms not actually registered with CFTC, but legally required to be registered, are also subject to reparations procedures.

3/ALJs and hearing officers differ primarily in the way Federal agencies can select and hire them. ALJs are tested, certified, and evaluated by the Office of Personnel Management. Hearing officers are chosen by the agency under different criteria.

If the registrant fails to respond or contact CFTC regarding the allegations in the original complaint, the chief ALJ will render a default decision. This is a short, perfunctory decision awarding a judgment to the customer, often used when the firm has gone out of business. With the firm out of business and often bankrupt or in receivership, the customer often gets no money back, even though the chief ALJ has awarded him/her a judgment.

If a complaint involves $5,000 or less, the chief ALJ assigns it to CFTC's sole hearing officer. The hearing officer will instruct the parties on how to proceed in the remaining steps of the reparations process. The parties will be able to question and request documentation from each other. 1/ The hearing officer will then render an initial decision based upon written submissions without an oral hearing.

If a complaint involves a claim of more than $5,000, the parties are entitled to an oral hearing before an ALJ unless both parties waive this right. 2/ In this case, the ALJ instructs the parties on how to proceed. The parties may also question and request documentation from each other. The ALJ will conduct an oral hearing and then render an initial decision.

If a respondent does not answer a CFTC request or order during this process, the presiding officer (ALJ or hearing officer) will render a default decision. If a complainant does not respond to a CFTC request or order, the presiding officer will dismiss the complaint. At any time during the adjudication process, parties may opt to settle their differences. Parties may choose to settle their differences as the process draws closer to the end, particularly before a hearing is held. As the parties (both complainants and respondents) evaluate the merits of the complaint, they may conclude that it is uneconomical and/or not in their interests to proceed with adjudication and, as a result, may prefer to settle.

Once the presiding officer makes an initial decision (judgment), parties can appeal the decision to the Commission. The opinions section 3/ manages the Commission's appellate

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1/The taking of an oral deposition (oral testimony under oath) before a hearing is not permitted in reparations unless both parties agree. (See p. 183 for further discussion.)

2/In line with one of our 1978 recommendations, the Congress increased the dollar limitation from $2,500 to $5,000 on the amount above which parties can demand oral hearings.

3/A separate and quasi-autonomous section of CFTC's Office of General Counsel.

workload by preparing background memoranda, orders, and opinions. Parties can initiate the appeals process by filing an application for review. The section must first determine whether to reject or accept the application for review. The Commission may also decide on its own initiative to review an initial decision, regardless of whether the parties file applications for review. If the Commission decides to review an initial decision, it asks the parties to file briefs outlining their positions. Parties may also ask to present their oral argument before the Commission. The Commission then reviews this documentation, reaches a decision on the question(s) involved, and issues an opinion.

After the Commission has either denied review of an initial decision or issued an opinion on review, the parties may appeal further to the U.S. Court of Appeals. The court will not usually begin the adjudication process anew; that is, conduct a proceeding designed to hear all the evidence in the case, even if previously presented. Rather, the appeals court will decide whether the Commission's opinion is consistent with the scope of the act and/or CFTC regulations. Since the program's inception in January 1976 through November 30, 1981, 11 decisions have been appealed to the U.S. Court of Appeals. After the U.S. Court of Appeals renders its decision, parties may further appeal their decisions to the U.S. Supreme Court. As of April 30, 1981, no one had appealed a reparations decision to this court.

THE COMPLAINTS SCREENING PROCESS WORKS RELATIVELY WELL

Since we issued our 1978 report, complaint screening has improved considerably because: (1) CFTC has implemented our prior recommendations aimed at improving the process and (2) the current director of the complaints section continuously monitors the flow of complaints and staff productivity in processing complaints. As the chart on page 169 shows, even though the complaints section has received an increasing number of complaints during the 3 most recent years, the number of complaints it is able to close and transfer to the hearings section has increased each year. Moreover, the time required to screen and process these cases has decreased since fiscal year 1978, as shown in the chart on page 171. The chief ALJ told us that the complaints section is now successfully screening out most complaints that fail to demonstrate grounds for legal action.

Estimated Workload for the Complaints Section (note a)

	Fiscal year		
	1979	1980	1981
Complaints received	903	1401	1417
Complaints closed (notes b and c)	285	1357	1771
Complaints that involve firms in bankruptcy and receivership (note d)	225	131	372
Pending at end of fiscal year (note b)	654	698	344

a/These figures reflect the best available CFTC count.

b/These figures include complaints pending from previous fiscal years.

c/The complaints section closes a complaint (1) by rejecting it and returning it to the customer if it finds no ground for legal action, (2) by forwarding it to the hearings section if it does find grounds for legal action, or (3) when the parties reach a settlement.

d/Complaints that involve firms in bankruptcy are stayed by law; however, those that involve firms in receivership are stayed by the Commission. According to the director, complaints section, most stayed complaints involve firms in receivership.

Source: CFTC, complaints section.

The complaints section has implemented our 1978 recommendations aimed at reducing the complaint screening backlog. According to the director, complaints section, in line with our recommendation that it assign more personnel to this function, the agency has increased the section's staff from five in 1978 to eight at present, including a director, an attorney, and three futures trading specialists. According to the director, complaints section, in line with another of our 1978 recommendations, the section has developed draft guidelines to facilitate and expedite the screening process. Although these guidelines were never formalized, we were told that the staff is using them on a day-to-day basis. Finally, according to the director, complaints section, the section has, consistent with our 1978 recommendation that reasonable time standards for processing be established, set a target of 90 days to either forward the complaint to the hearings section or return it to the customer if the section determines that no grounds exist for legal action. As of fiscal year 1981, the complaints section has not met this 90-day target; however, it has shortened the time required to process complaints.

DESPITE SIGNIFICANT PROGRESS IN SOME AREAS, OTHER ASPECTS OF THE REPARATIONS PROGRAM STILL NEED IMPROVEMENT

Although improvements have been made in the initial screening of complaints, the reparations program continues to suffer from delays and backlogs and, as a result, is not achieving the objectives that the Congress and Commission set for it. The adjudication and appeals processes are slow relative to other available alternatives, difficult for customers to understand, and often expensive to use. As the chart on page 171 illustrates, for complaints originally filed with CFTC in fiscal years 1976, 1977, and 1978, an average of 1,729 days (about 5 years), 1,173 days (about 3 years), and 1,129 days (about 3 years), respectively, were required for a complaint to proceed through the entire reparations process, including appeals to the Commission. 1/ These statistics show some improvement in the time required to complete the program; however, the process continues to be lengthy because of delays in assigning complaints to presiding officers for adjudication and delays involved in the Commission's appeals process. As a result, respondents often have little incentive to settle disputes promptly. Moreover, because of the time required to complete the entire reparations process, relatively few customers have actually collected on claims. Since the reparations process is difficult to understand, customers often neither know how to proceed nor even comprehend the meaning of the judgments they receive. If customers choose to hire attorneys, the reparations process can be very expensive.

1/Although these statistics represent the estimated average time required for a complaint to proceed through the entire reparations process, parties may opt to settle their disputes at any point, thus shortening the amount of time necessary to close the complaint. As the chart on page 176 illustrates, 424 reparations complaints (out of 2,747 complaints forwarded to the hearings section) have been settled after the complaints section fowarded them to the hearings section. CFTC does not have comparable statistics on the average time required to complete the entire reparations process for fiscal years 1979, 1980, and 1981. (App. XI shows the number of complaints CFTC used to calculate the average time to complete the process.)

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Estimated Average Number of Days CFTC Took To Move Complaints Through the Reparations Process

	Fiscal year (note a)					
	1976	1977	1978	1979	1980	1981
Average number of days from initial filing to a disposition by the complaints section	67	100	247	194	135	119
Average number of days from forwarding the complaint from the complaints section to assignment to a presiding officer	42	70	160	373	b/289	b/100
Average number of days from assignment to a presiding officer to disposition of the complaint in the hearings section	422	366	438	b/222	b/76	b/64
Average number of days from the time an application for review is filed to the time the Commission decides to grant or deny review	410	294	158	(c)	(c)	(c)
If an appeal is granted, average number of days from granting of review to Commission issuance of either an opinion and/or order	788	343	126	(c)	(c)	(c)
Total average number of days	1,729	1,173	1,129	(b, c)	(b, c)	(b, c)

a/Calculations are based upon the flow of reparations complaints originally docketed in each fiscal year and not upon the disposition rates for any particular section during any one year. For example, it took a total average of 1,729 days to dispose of reparations complaints filed in fiscal year 1976. CFTC developed these statistics and based them on nonscientific samples.

b/These statistics appear to show some improvement in the time required to complete these steps of the reparations process. CFTC officials who prepared these statistics caution that the number of complaints used to determine these averages were, in their view, unacceptably small, and as a result these statistics may not accurately represent the average required time.

c/According to CFTC officials who prepared this data, the opinions section has not yet disposed of enough cases in these categories to develop accurate statistics.

Source: CFTC, complaints section.

The reparations process takes longer than other means of resolving disputes

The process of adjudicating a reparations claim is a lengthy one, and is not generally perceived as being faster than the available alternatives of court litigation or arbitration. We recognize that any adjudication process will have some delays. For example, during the reparations process parties involved are given the opportunity to question each other and exchange documentation. The presiding officers set the time limits for this activity, which is usually 90 days. In addition, parties are allowed to request time extensions. However, we believe that the chart on page 171 demonstrates that long periods of time passed between assignment and decision on complaints forwarded from the complaints section to the hearings section in fiscal years 1976-79. According to the CFTC official who prepared the data, in the case of those complaints forwarded from the complaints section to the hearings section in fiscal years 1979-81, the sample of complaints used to determine these average times was too small to develop accurate statistics, even though CFTC compiled and reported them.

Reparations proceedings are much slower than most arbitration forums. 1/ From the time a complaint is filed, arbitration usually takes only a relatively few months to provide a decision. Reparations complaints are also not decided more quickly than complaints brought to Federal District Court. According to 9 out of 13 commodity attorneys we interviewed (representing both customers and registrants), reparations proceedings take about the same time or longer than Federal District Court cases, depending upon the court in question.

CFTC regulations require that complaints be assigned to a presiding officer immediately after the formal adjudication process begins. 2/ As the chart on page 171 illustrates, the chief ALJ has held complaints for long periods before assigning them

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1/Various arbitration forums are available to settle customer claims. All 11 commodity exchanges have arbitration programs. In addition, private organizations, such as the American Arbitration Association, the New York Stock Exchange, and the National Association of Securities Dealers, arbitrate commodity disputes. NFA also plans to have an arbitration program.

2/The adjudication process formally begins after CFTC receives the $25 filing fee from the complainant and forwards the complaint to the hearings section. According to the chief ALJ, claims involving less than $5,000 are now immediately assigned to the hearing officer but claims of more than $5,000 are not.

to particular ALJs. When we began our audit work in February 1981, the five presiding officers had on their combined dockets 267 complaints, 49 of which were stayed (inactive). The average number of active complaints on their dockets was only 44. A count taken in March 1981 showed that 753 complaints had not been assigned. In the months before our audit, the chief ALJ held back in assigning complaints and in some months assigned less than 10 complaints to all the presiding officers. According to the chief ALJ, he did this in order to assist and encourage the ALJs to hear cases already on their dockets and to write up their decisions. He told us that another reason for taking this action was that he expected the Commission to approve new rules that would allow the hearings section to send complaints back to the complaints section for further investigation and screening. The Commission never adopted the rules.

Delay in the assignment of cases discourages complaint settlement because during this period of inactivity the parties involved are neither communicating, refining the issues, nor evaluating the complaint's merits. According to one ALJ, however, as soon as the chief ALJ assigns the complaint, the ALJ can quickly notify and instruct the parties. The parties can then begin to communicate with one another, requesting and exchanging information. As a result, the parties are forced to act on the complaint. According to all the ALJs we interviewed, the simple act of assigning the complaint and notifying and instructing the parties can encourage settlement before a hearing ever takes place.

According to a CFTC attorney involved in the reparations program, after a case has been assigned and the presiding officer instructs the parties, about 15 percent of complainants and respondents fail to respond to these instructions. According to this attorney, in such cases, presiding officers can easily dispose of the complaints by either rendering default decisions or dismissing the complaints outright. This practice also increases the complaint disposition rate, further reducing the backlog of claims.

To encourage settlements and hasten the adjudication process, we believe that the chief ALJ needs to assign complaints to the ALJs immediately after the hearings section receives the filing fee. The chief ALJ has hesitated to assign reparations complaints immediately to the ALJs because in his opinion the ALJs would then be burdened with phone calls and questions from the parties. As a result, they would not be able to manage their caseloads.

Since March 1981, the chief ALJ increased the number of complaints he assigned to the presiding officers. As of February 28, 1982, the presiding officers had approximately 884 complaints on their combined dockets, 68 of which were stayed. According to the staff member who accounts for unassigned complaints, as of March 1982, there were approximately 350 unassigned complaints in the hearings section. While this increase in the number of complaints assigned is encouraging, we believe that all complaints should be assigned immediately. In our opinion, this approach would be a more effective way to increase ALJ productivity. Furthermore, since CFTC has recently designated a qualified staff member to answer the parties' questions concerning the reparations process (discussed on p. 181), the ALJs will be less burdened with parties' phone calls and questions.

The chief ALJ told us that he has not established any performance standards for ALJs in terms of quality and quantity of work. In some cases, the ALJs have taken up to 2 years after a hearing to write an initial reparations decision. While we recognize that some complaints may be difficult and complex, we believe performance standards would be important tools in tracking work productivity and determining which ALJs are not working to their full potential to expedite the process. Currently, the chief ALJ "discusses" productivity problems with individual ALJs, as necessary.

The chief ALJ has not established performance standards because he believes that such standards are not consistent with the purposes and intent of the Administrative Procedure Act and are perhaps illegal. 1/ However, we believe that agencies may properly exercise a limited degree of control over ALJs' activities consistent with the act's protections for ALJ independence and objectivity. Clear and more objective standards would strengthen the chief ALJ's management control over the ALJs. Furthermore, as we have reported elsewhere, 2/ written performance standards also act as an important management tool, helping agencies to determine the actual number of ALJs needed to accomplish their objectives.

Another factor slowing down the adjudication process is the fact that CFTC has only four ALJs and one hearing officer to adjudicate reparations complaints. Moreover, ALJs divide their time between hearing enforcement and reparations cases, with priority given to enforcement.

Our 1978 report recommended that CFTC assign more staff to hear reparations cases and thereby reduce the backlog. According

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1/The Administrative Procedure Act outlines the legal requirements that Federal agencies must adhere to when adjudication is required by statute. The purpose of the act is to protect the parties' rights in adjudication proceedings before Government agencies.

2/"Administrative Law Process: Better Management Is Needed" (FPCD-78-25, May 15, 1978).

to the chief ALJ, CFTC hired an additional ALJ in 1980; however, he resigned after only a few months. The hearings officer told us that he was appointed in September 1980 to write initial decisions for complaints involving $5,000 or less. 1/ CFTC hired a fifth ALJ on April 4, 1982. A recent CFTC budget document indicates that this addition will permit the reassignment of over 100 cases for ultimate disposition.

We recommended in 1978 that, as in the case of initial screening of complaints, CFTC establish time standards to improve the operating efficiency of the adjudication process. The agency has not implemented this recommendation. CFTC's chief ALJ has argued that establishing time standards may not be allowed under the Administrative Procedure Act. However, we believe that Federal agencies may take appropriate actions to manage ALJs' activities consistent with the act's protections for ALJ independence and objectivity.

Because the adjudication process is lengthy, the backlog of complaints that we reported in our 1978 report has continued to grow. As the chart on page 176 illustrates, in each recent year the hearings section has docketed more cases and, despite recent higher disposition rates, the number of complaints pending at the end of each year continues to increase. In a recent document submitted to the Office of Management and Budget, CFTC estimated that the adjudication backlog will remain high in future years, even though CFTC expects to hire an additional ALJ.

1/CFTC originally hired the hearing officer to be a judicial administrator managing the entire reparations program. However, this individual is currently deciding reparations complaints that involve claims of $5,000 or less.

Hearings Section Disposition Statistics

		Type of disposition					
Fiscal year	Complaints received	A Initial decision	B Settlement	C Default	D Dismissed for cause	E Total (A thru D)	Complaints pending end of fiscal year
1976	25	-	-	-	-	0	25
1977	319	31	19	4	16	70	274
1978	303	122	75	8	29	234	343
1979	535	68	76	10	24	178	a/700
1980	747	89	89	43	54	275	a/1,172
1981	818	201	165	175	60	601	a/1,389
Total	2,747	511	424	240	183	1,358	N/A
1982 estimates (note b)	c/900	205	165	85	85	540	d/750
1983 estimates (note e)	c/900	300	250	150	200	900	d/750

a/We computed these figures.

b/1982 estimates are based upon the current level of funding, including an additional ALJ which CFTC expects to hire.

c/CFTC estimates that the complaints section will forward to the hearings section 900 complaints in fiscal years 1982 and 1983. CFTC used these estimates to prepare budget documents. However, the number of complaints that the hearings section receives is not dependent upon CFTC's budget or staffing levels.

d/The complaints pending column does not include complaints from previous fiscal years.

e/1983 estimates are based upon an increased level of funding, including an additional secretary.

Source: CFTC, hearings section.

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As the chart on page 171 illustrates, both the opinions section, which manages the Commission's appellate docket, and the Commission, which issues appeal orders, take a long time to dispose of reparations decisions. Although CFTC did not supply us with time lag statistics for fiscal year 1981, we determined the time it took the opinions section and Commission to dispose of cases in that fiscal year (regardless of the year that the complaint was orginally filed). Our analysis showed that it took an average of 476 days just to study an initial decision and decide against granting an appeal of the presiding officer's initial decision. Since the beginning of fiscal year 1978, the Commission has denied appeal 56 times (out of 171 applications for review filed). In addition, since fiscal year 1978, the Commission has been able to dispose of 20 cases through miscellaneous orders (other than issuing denials or opinions). 1/ Further, in fiscal year 1981, for those appeals granted by the Commission or taken on its own initiative, the Commission took an average of 898 days to issue its opinion. Since the beginning of fiscal year 1978, the Commission has issued 45 opinions and granted review 56 times. 2/ These delays have resulted in a crowded appellate docket, as the chart on page 178 illustrates.

1/For example, the Commission dismissed several cases when parties failed to submit briefs after applications for review had been granted.

2/As we recommended in our 1978 report, the Commission has reviewed more initial decisions to establish legal precedents. Legal precedents help the complaints section screen out nonmeritorious complaints and help the presiding officers decide and frame their decisions. According to the chief ALJ, in these opinions the Commission has decided important legal questions such as the definition of fraud in the commodities industry, whether to award attorney fees, and whether exchange rules violations can be brought to reparations. He concluded that the lack of Commission opinions to set precedents is no longer a significant problem.

Opinions Section Workload

	A	B	C	D	E	F	G
Fiscal year	Applications for review filed	Review granted on CFTC initiative	Review granted (note a)	Review denied	Cases decided (note a)	Miscellaneous dispositions	Cases pending (note b)
1978	33	2	22	7	11	2	43
1979	32	3	11	21	2	5	50
1980	43	6	20	9	12	4	74
1981	63	2	3	19	20	9	91
Total	171	13	56	56	45	20	

a/Cases in this category include those listed in column B—review granted on Commission initiative—plus applications for review filed and granted.

b/To calculate the number of cases pending at the end of each fiscal year (column G), we totaled columns A and B and subtracted from that total columns D, E, and F. This category includes complaints pending from previous fiscal years, including 28 from fiscal year 1977.

Source: CFTC, opinions section.

According to the director, opinions section, that section is presently not staffed to effectively handle CFTC's growing enforcement and reparations caseload. Since our 1978 review, CFTC has increased the size of the section's staff from two attorneys in 1978 to six at present. However, the increase in staff has not affected the section's disposition rate for initial decisions appealed to the Commission because, according to the director, opinions section, the section gives first priority to matters the Commission wants expedited, second to interlocutory appeals, 1/ third to registration cases, fourth to other enforcement cases, and fifth to reparations decisions. The director, opinions section, has presently assigned only one and a half staff years to work on reparations decisions.

According to the director, opinions section, each step in the appeals process takes much time and preparation. He said that opinions section attorneys require an average of 30-60 hours to prepare a background memorandum recommending to the Commission to either deny or grant an application for Commission review. Moreover, he said that if the Commission grants review, the same amount of staff time is usually needed to prepare a draft opinion for Commission approval.

As shown by the chart on page 178, the opinions section's workload has increased from 35 appeals in fiscal year 1978 to 65 in fiscal year 1981. (These figures include the number of applications for review filed and the number of times the Commission granted review on its own initiative.) As the reparations program has matured and as more complaints have been filed, accepted, and adjudicated, the number of applications for review has also increased. As a result of an increased workload and of the limiting factors discussed above, the opinions section backlog has grown, and the time it takes to dispose of reparations decisions remains quite long.

Because the appeals process is lengthy (for example, it took an average of 898 days from filing of the application for review to issuance of the Commission's opinion in fiscal year 1981), respondents have had an incentive to appeal unfavorable decisions --they can delay paying a judgment to a complainant. One commodity attorney we interviewed characterized CFTC's appeals process as a "freebie" in that the delay provides an opportunity to retain the use of the money that might otherwise have to be paid in a reparations award. He recommends to all his registrant clients that they appeal unfavorable decisions for this reason.

1/An interlocutory appeal is a request by a party that the Commission review a ruling made by the presiding officer before that officer has rendered his or her initial decision on the merits of the case.

Until recently CFTC required unsuccessful respondents to pay complainants only 12 percent interest from the time the violation occurred. 1/ As a result of this low interest rate, delay and legal maneuvering could have easily benefited the registrant. In February 1982, the interest rate rose to 20 percent and the financial incentive to protract reparations proceedings may be eliminated.

Few individuals have received money because the reparations process is slow and protracted, explainable in part by the fact that respondents can delay final decisions through appeals. According to the Executive Director, as of August 1981 only 53 parties had received money as a result of reparations decisions rendered by presiding officers. This figure was compiled after the hearings section closed 1,238 complaints. Out of 475 initial decisions and 196 default decisions, the presiding officers ruled against complainants only 84 times. The number of complainants who received money is extremely low compared with the total number of complaints that have been filed (4,000 as of September 1981) and accepted for adjudication (2,607 as of September 1981) since the reparations program began in 1976. This is true even allowing for settlements and dismissals.

Customers find the reparations process confusing, cumbersome, and complex

The simple, easy-to-use reparations program envisioned by the Congress and Commission still does not exist. Based upon our conversations with 24 complainants, 2/ we found that 15 had difficulty understanding CFTC's rules and procedures. Several complainants did not understand the presiding officer's decision or how to proceed after the decision was rendered. This is particularly troublesome when the respondent (registrant firm) has gone out of business or when the respondent cannot be located. In such cases, many complainants did not understand the procedures required to enforce the decisions or collect their judgments. Some complainants found it necessary to make numerous phone calls to CFTC to find out how to proceed, and in some cases they missed or almost missed deadlines. Even some of the attorneys who represent parties in reparations proceedings told us that

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1/According to the director, opinions section, CFTC uses the interest rate established by the Internal Revenue Service.

2/We drew these complainants from a CFTC list of presiding officers' decisions. The complainants we contacted represented a cross section of the various types of dispositions; for example, initial decisions or defaults. They all received their judgments during the course of our review.

they have difficulty following CFTC's rules. CFTC, at the time of our audit work, had not formally designated staff to answer public inquiries regarding the reparations process. However, the practice of designating a paralegal specialist as a resource person available to the parties, begun in December 1981, should make the program easier to use.

Our 1978 report recommended that CFTC perform a study, with outside assistance, to determine how the reparations regulations could be rewritten to simplify the process and make it easier to understand. CFTC completed an in-house study in November 1978 that concluded that the reparations regulations generally had worked well in the adjudicatory process. It further concluded that simplifying the rules might lead to legal ambiguities requiring either the chief ALJ or Commission to clarify decisions. CFTC also concluded that rewriting the rules would destroy legal precedents established in earlier Commission decisions (discussed on p. 177). The study recommended that, instead of rewriting the rules, CFTC publish a detailed information pamphlet describing the reparations process.

CFTC published an information pamphlet concerning the reparations program in 1979. However, CFTC no longer uses this pamphlet because it is outdated. While we appreciate CFTC's concerns, we still believe the reparations regulations need to be rewritten so that complainants can better understand the entire process. While we recognize that CFTC may have difficulty in dealing with the potential for ambiguity, we do not see this as an insurmountable obstacle to simplification. Moreover, CFTC could incorporate the results of important Commission decisions into any new regulations to retain the benefit of prior legal precedent.

Compared with reparations, arbitration is relatively easy to use. Arbitration panels are not generally bound by the formal rules of evidence. These panels will usually accept whatever information the parties wish to submit to help them reach a decision. According to a CFTC study, 75 percent of all reparations complainants whose claims are forwarded to the hearings section for adjudication hire attorneys to represent them. By comparison, according to this preliminary analysis, only 18 percent of complainants in arbitration hire attorneys. We believe the lesser reliance on legal counsel in arbitration is a reflection of the fact that arbitration is easier for complainants to understand and use than reparations.

The process can be expensive

The reparations process, including both initial adjudication and subsequent appeals, can be very expensive for complainants if they hire attorneys, thus causing it to fail to meet another congressional and agency objective. As discussed, the complexity of the process often forces complainants into making this choice.

Some of the attorneys we interviewed (from a variety of backgrounds) agreed that because the reparations process is not simple, complainants would be well-advised to retain counsel, particularly in view of the fact that the respondents are likely to be represented by legal counsel. According to the chief ALJ, a complainant should hire an attorney in more complex and difficult cases while in simpler cases complainants can represent themselves.

The commodity attorneys we interviewed cited fees ranging from $1,500 to $10,000 for representing complainants in smaller reparations claims. If one party appeals the initial decision, attorneys will have to spend more time on the case, preparing necessary applications, responses, and briefs, which further increases the cost.

Parties can generally settle disputes much less expensively in arbitration than in reparations. [1] While most arbitration programs charge fees higher than CFTC's complaint filing fee (which is currently $25), it is still relatively cheaper to resolve claims in arbitration forums than in reparations. As discussed above, most complainants do not hire attorneys to represent them in arbitration proceedings, thus greatly saving on their overall costs. Furthermore, according to an experienced commodity attorney, even if a customer chooses to hire an attorney for arbitration, legal fees should still be less than in reparations because arbitration forums provide decisions more quickly and with less procedural formality.

Practicing commodity attorneys we interviewed indicated that it is probably somewhat more expensive to adjudicate a complaint through the courts than in reparations. First, parties often engage in jurisdictional disputes even before the merits of the complaint are addressed. State court jurisdiction may depend upon such factors as the place of the plaintiff's residence and the defendant's place of business. In Federal court, defendants have often challenged the jurisdiction of the court even to hear private commodity disputes. These jurisdictional battles can consume much time and expensive legal resources. These expenses are spared in the reparations program, because CFTC has unquestioned

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1/Most arbitration forums charge fees based upon the value of the claim. Each organization has its own fee schedule. While some fee schedules are more complex than others, the Coffee, Sugar and Cocoa Exchange offers its customers a relatively simple one. The minimum fee this exchange charges is $100. The maximum it charges is $250, plus 1 percent of the amount over $10,000 (for example, the exchange would charge $300 to arbitrate a $15,000 claim).

nationwide jurisdiction to decide private commodity-related complaints.

Litigation can also be expensive because court procedures allow parties to take oral depositions, which can be costly. As discussed above, parties cannot demand oral depositions during reparations proceedings. Finally, considerable time may be required in civil court proceedings just to "educate" the judge and the jury regarding the underlying principles of commodity futures trading. This time-consuming process is not necessary in reparations because CFTC's presiding officers have the necessary subject matter expertise.

MANAGEMENT INFORMATION CAPABILITIES ARE INADEQUATE

CFTC does not systematically collect and analyze sufficient management information to enable it to properly evaluate the reparations program. CFTC has not automated information concerning the reparations program, further hampering systematic monitoring efforts. CFTC needs to continually collect and analyze management information so that (1) it can accurately inform the public as to how long an average reparations procedure may be expected to take, (2) it and the Congress can monitor and evaluate the performance of the program, and (3) the Congress will have the necessary information to determine whether the reparations program's performance and benefits justify its costs and continuation.

Management information collection and analysis is insufficient

The only operating statistics CFTC regularly collects, aggregates, and reports are the number of complaints filed and the disposition or closure rates of the complaints, hearings, and opinions sections. The opinions section only regularly compiles and reports an aggregate disposition rate; it does not break down its disposition rate by type of Commission action. Because CFTC only compiles information on disposition rates, it cannot presently evaluate staff productivity, processing backlogs, or time lags to effectively monitor the program.

In previous years CFTC collected a limited amount of management information pertaining to the reparations program on a special request basis. Much of the information we used to evaluate the reparations program was of this type. Recently, CFTC has begun to collect more information concerning the program and its operation. These recent efforts have coincided with our management information requests.

Management information that CFTC collects manually requires considerable time to develop. For example, CFTC did not know how long reparations procedures took on average. For almost

2 weeks, most of the complaints section staff ceased their usual tasks to compile time lag statistics by manually sorting through a series of docket files. To update these statistics in the future, assuming present procedures continue, the staff would have to repeat the same time-consuming process.

We believe that to sufficiently monitor and evaluate the reparations program, CFTC needs to continually collect and analyze statistics concerning, among other things: productivity, time lags, the number of complainants who represent themselves, the dollar amounts of damages claimed, the dollar amounts of judgments, the dollar amounts that registrants actually pay customers, the number of applications for review denied, the number of initial decisions for which the Commission grants review, and the number of Commission opinions. If CFTC were to collect, analyze, and report this type of management information, the Congress, CFTC, and the public would be far better equipped to make informed decisions concerning the reparations program. CFTC recognizes that it needs to systematically collect more management information. In order to collect, aggregate, and analyze additional management information, CFTC leased an elaborate wordprocessor. However, as discussed below, this system has limited data processing capabilities.

Current actions to automate management information are deficient; plans for future action are promising

CFTC will not be able to adequately develop management information if it adheres to its stated intention of using an elaborate wordprocessor of minimum computational ability. 1/ Our review revealed that CFTC did not adequately define its management information requirements for reparations or investigate alternative equipment to satisfy its information processing needs before it leased its current wordprocessor.

The wordprocessing system that CFTC leased can record and store information on each reparations complaint on magnetic disk. In addition, this system can locate the stored information to identify and update data regarding the status of a complaint. The system can also search for and total selected aspects of stored data, such as the number of complaints

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1/According to a CFTC contract specialist, CFTC installed the wordprocessor system in Dec. 1980. However, the director, complaints section, said that CFTC did not begin to collect and code information to put into the system until Oct. 1981. As of Jan. 1982 CFTC had not begun to put any information into the system. The equipment, which remained idle for over a year due to hiring and personnel restrictions, was removed in early May 1982 after CFTC determined that it was not suited to the needs of the reparations program.

assigned to a particular ALJ. However, the system has certain limitations as a data processor that will limit CFTC's ability to develop an optimum management information system for reparations. For example, CFTC's wordprocessor cannot perform any calculations on stored data other than counting it. It cannot calculate the average number of days that ALJs have taken to dispose of reparations complaints. To calculate those statistics using the system, analysts will have to generate a series of totals and then manually compute the necessary figures.

The former judicial administrator, who is now serving as the hearings officer, said that he was told to select this particular system because another CFTC office had used it and was well-satisfied. We believe, however, that as a result of insufficient analysis of its data processing needs, the equipment CFTC leased and plans to use is not particularly well-suited to the reparations management information requirements that both we and CFTC identified.

CFTC has recently begun a process that will include a comprehensive review and identification of its information requirements and ADP needs. According to the Director, ADP Services, CFTC will include the reparations program in this study. He also informed us that he plans to include the reparations program in an integrated computer system; that is, one that will bring together management information compiled in the Division of Enforcement, the Office of General Counsel, and the registration unit (part of the Division of Trading and Markets).

Because the Commission has set other priorities for its ADP staff, it has not begun to develop this integrated computer system. However, we believe that these plans are an important step in the right direction. If they are implemented, we believe the Commission will be able to better monitor and evaluate the reparations program.

PRESENTLY AVAILABLE ALTERNATIVES TO THE REPARATIONS PROGRAM HAVE PROBLEMS OF THEIR OWN

The currently available alternatives to reparations--Federal and State court litigation as well as various arbitration forums--have shortcomings and presently do not constitute fully satisfactory substitutes for CFTC's reparations program. Court litigation, because of expense, is generally a practical alternative only for larger claims. While arbitration is in theory a simple, expeditious, and cost-effective alternative for smaller claims, it has never won wide public acceptance for resolution of commodity claims.

Court litigation: an alternative for larger and more complex claims

The high cost of court litigation makes it a plausible alternative only for commodity claims involving large amounts and/or difficult and complex issues. Three commodity attorneys we interviewed, said that they usually recommend to clients with smaller claims (less than $100,000) that they go to reparations because they would probably not find it economical to bring these claims to court. Recent CFTC reparations statistics appear to lend support to the belief that claims of moderate size come to reparations. As the chart below illustrates, the majority of reparations complaints involve claims of less than $10,000, while 83 percent fall under $25,000.

Profile of Complaints Received in CFTC's Complaints Section in Fiscal Year 1981 (note a)

Dollar range	Number of complaints	Percent of total (note b)
$1 - 1,499	80	6
$1,500 - 9,999	618	47
$10,000 - 24,999	403	30
$25,000 - 49,999	102	8
$50,000 - 100,000	54	4
Above $100,000	70	5
Total	1,327	100

a/This chart was prepared by CFTC on Sept. 15, 1981, and does not include all complaints received in fiscal year 1981.

b/We calculated the percentages.

Source: CFTC, complaints section.

The question of Federal court jurisdiction over commodity disputes has recently been decided by the Supreme Court. 1/ The Supreme Court reviewed the question of whether commodity customers have an implied private right of action under the Commodity Exchange Act to sue CFTC registrants for violations of either the act or of CFTC regulations. The Supreme Court's review of the legislative history of the Commodity Exchange Act determined that preservation of the implied right of action was what the Congress actually intended when it amended the act in 1974. In

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1/Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran No. 80-203 (Decided May 3, 1982).

the Supreme Court's view, the reparations and arbitration provisions were intended to supplement rather than supplant the implied private right of action.

Arbitration: not yet an effective alternative

Commodity exchanges and various private organizations such as the American Arbitration Association, the New York Stock Exchange, and the National Association of Securities Dealers, now conduct arbitration programs. Arbitration is potentially an effective and attractive alternative to reparations, especially for smaller claims. Unfortunately, problems exist that up until now have prevented the full realization of arbitration's potential. CFTC could help to overcome these impediments to fuller and more effective use of arbitration by (1) working closely with the industry to develop arbitration programs that overcome the perceived objectionable features and limiting characteristics of existing programs (2) by ensuring that arbitration programs conform to legal requirements (including the agency's own regulations) and (3) by publicizing the availability of arbitration as an alternative to reparations.

The act requires all exchanges to offer a fair and equitable procedure either through arbitration or otherwise 1/ for the settlement of customers' claims and grievances against an exchange member or employee. The exchanges have all chosen to offer arbitration programs. According to CFTC's interpretation of the act and as reflected in the regulations, an exchange member must agree, for claims of less than $15,000, to arbitrate disputes or participate in other approved forums if the customer so chooses. 2/ CFTC regulations require that exchange arbitration programs be prompt, objective, and impartial. Under these regulations, arbitration forums are not bound to the formal rules of evidence. However, each party must be allowed to examine all relevant documents pertaining to the claim and to question the other side's witnesses. In addition, CFTC regulations allow customers to opt for a mixed arbitration panel, one that contains

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1/In lieu of its own arbitration program, exchanges may delegate claims submitted by customers to a registered futures association for settlement. NFA is a registered futures association; however, it has not yet begun its arbitration program.

2/But see Board of Trade of the City of Chicago v. Commodity Futures Trading Commission No. 81. C 7175 (N.D. Ill., Oral Decision on Feb. 25, 1982) which views mandatory arbitration as unconstitutional. CFTC filed its notice of appeal on Apr. 26, 1982, and the case is now docketed with the Seventh Circuit Court of Appeals in Chicago.

a majority of panelists not associated with the exchange or its members. This requirement alleviates concerns about possible bias on the part of the arbitration panelists.

In addition to commodity exchanges, the other groups noted above will arbitrate commodity disputes, applying their own rules. This noncommodity exchange arbitration is voluntary for both the customer and the registrant, unless (1) the customer has signed a predispute arbitration agreement with the party against whom he or she subsequently lodges a claim or (2) the registrant is also a member of the private organization. Predispute arbitration agreements, if they are entered into, are made when the commodity account is opened with an FCM or other registered entity. These agreements specify that the customer will submit to arbitration, usually under the rules of a designated private organization.

The Commission has recently proposed to amend its arbitration rules to encourage customers to use arbitration forums to settle commodity customer disputes and thereby reduce the backlog of reparations proceedings. These new rules would not allow customers who had signed a predispute arbitration agreement to opt for reparations after a dispute arose. 1/ The proposed regulations would require, among other things, that if a dispute arises (assuming the customer has signed an agreement) the customer must be given the choice of arbitration forums from a list of at least two organizations. One organization listed must be the exchange upon which the transaction giving rise to the dispute was executed or could have been executed, although NFA can take the place of exchange arbitration. In addition, at least one organization on the list must conduct arbitration in several cities. All organizations listed must provide for mixed panels.

While arbitration is potentially the least cumbersome and costly forum available to settle commodity disputes, presently available arbitration procedures and forums have certain drawbacks and inherently limiting features that prevent the wide use of arbitration in the commodity industry today. Because arbitration panels in both exchange and private programs usually include industry officials or exchange members, customers often perceive the panels to be less than completely impartial. For the same reason, attorneys sometimes recommend that customers not use these forums. Many customers are not even aware that arbitration forums exist as an alternative to the reparations

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1/Under existing CFTC regulations, even if customers sign a predispute arbitration agreement, they still have 45 days to file a reparations claim once they receive notice that the registrant will demand arbitration under the agreement.

program. Of the 24 reparations complainants we interviewed, only 6 were aware that arbitration was also an available alternative.

In addition, exchange arbitration forums have especially limited jurisdiction. Exchanges can only arbitrate disputes that concern their members' actions on that exchange. For example, allegations of poor contract execution concerning a commodity traded on a particular exchange could be arbitrated by that exchange. However, allegations of poor contract execution concerning transactions made on several exchanges could not be arbitrated in a single proceeding at any one of them. Instead, each occurrence would have to be arbitrated at the particular exchange where it took place. Furthermore, as a matter of practice, exchanges will only hold arbitration hearings in the cities where they are located, further limiting the appeal of exchange arbitration. Finally, the present $15,000 ceiling on mandatory customer-member arbitration limits the number of claims that can be arbitrated. As the chart on page 186 illustrates, if this dollar limitation were raised to $25,000, 83 percent, or the vast majority of claims filed in the complaints section in fiscal year 1981, would not have been precluded from exchange arbitration. 1/

CFTC needs to do more to make arbitration a workable alternative to reparations

Even though CFTC has received, reviewed, and approved complete arbitration rule packages from all 11 exchanges, it has taken little action to ensure that the exchanges have arbitration programs that meet legislative and agency requirements. 2/ For example, CFTC believed that the Chicago Board of Trade's original arbitration code failed to meet requirements because it did not provide for mandatory customer-member arbitration for disputes of $15,000 or less. In July 1980 the Commission decided to inform the Chicago Board of Trade that if it did not modify its arbitration rules, CFTC would initiate a proceeding to determine whether

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1/We calculated this $25,000 limitation partially upon the basis of projected inflation. Assuming a 10-percent inflation rate and that the next reauthorization will occur in 4 years (1986), it will take $22,000 to equal the purchasing power of $15,000 today.

2/In Dec. 1981 CFTC fully approved the Chicago Board of Trade's entire package of arbitration rules even though it was originally submitted in Feb. 1977.

to do so itself. 1/ After this decision, the Commission immediately notified the Chicago Board of Trade of its intentions and gave it 60 days to modify its rules. The Chicago Board of Trade failed to do this because it disagreed with CFTC's legal interpretation of the act relating to exchange arbitration and with CFTC's procedures for altering exchange rules. Nevertheless, the Commission took no formal action until January 13, 1981, when it announced in the Federal Register its intention to modify the exchange's rules. The Commission did not take any further formal action until November 17, 1981, when it formally decided to amend the Board of Trade's arbitration rules to reflect its interpretation of the act's requirement that exchanges compel their members to participate in customer-initiated arbitration proceedings involving claims of $15,000 or less. This rule became effective on December 24, 1981.

CFTC officials acknowledged to us that they know very little about exchange arbitration programs. According to the Deputy Director, Division of Trading and Markets, no previous rule enforcement review, with the exception of a recent review at the Chicago Mercantile Exchange, has examined the operation of an exchange's arbitration program. One result of this lack of review (and consequent lack of information) is that CFTC was not aware of the information the Chicago Board of Trade was providing the public concerning its arbitration program and the exchange rules that govern it. Until we informed CFTC otherwise, it believed that the Chicago Board of Trade was providing the public a set of up-to-date rules that contained the most recent amendments CFTC had approved. In fact, the rules made available by the Chicago Board of Trade lacked amendments that CFTC had approved in July 1980, including a provision allowing customers to elect mixed panels which the exchange had never adopted even though it had submitted the provision to CFTC as a rule change.

NFA arbitration forum: a promising alternative

One of the activities expected to be carried out by NFA is the arbitration of customer-member disputes. An NFA-proposed arbitration program offers a more promising alternative to reparations than does exchange arbitration because it could overcome some of the problems discussed above. NFA's arbitration program is not yet operational. NFA will have a comprehensive membership consisting of exchanges, FCMs, CTAs, CPOs, and APs. As a result, NFA will have jurisdiction to handle a wide variety of arbitration disputes involving more than a single exchange. Further, since NFA's membership will be broad and diverse (much larger

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1/Under sections 5a(12) and 8a(7) of the act, CFTC can disapprove and alter or supplement an exchange's rules.

than any single exchange), its arbitration program may well be able to overcome some of the concerns about anticustomer bias, which reportedly have limited the public's confidence in exchange arbitration. NFA will have jurisdiction to arbitrate disputes that involve contracts traded at any commodity exchange. In addition, any particular exchange will be able to ask NFA to arbitrate disputes originating at that exchange.

According to an attorney representing NFA, the association will operate nationwide, holding arbitration hearings in several cities, although it has not yet determined which cities. Nationwide operation will be an important advantage over current commodity exchange arbitration programs because complainants will have a choice of locations to arbitrate disputes, thus reducing travel costs and inconveniences. The NFA attorney who wrote the arbitration code and the Deputy Director, Division of Trading and Markets, who was responsible for evaluating it, both believe that NFA's arbitration program has the potential to be successful because NFA's code will overcome some of the problems that we identified with commodity exchange programs.

Notwithstanding the significant improvement which it promises, NFA's proposed arbitration program may fall short of its full potential. NFA's proposed code of arbitration, as presently envisioned, will include several restrictions. As in commodity exchange arbitration, NFA's dollar limitation on mandatory customer-member arbitration is set by statute and will be $15,000. As previously discussed, this amount appears to be too low in light of present conditions. Moreover, unlike some other arbitration programs, NFA's proposed code will not include a provision for resolving small disputes on the basis of written submissions. We believe that such procedures would allow customers to more economically settle small claims.

NFA could become the major arbitration program for commodity disputes if the exchanges were to refer the disputes they receive to it; if customer predispute arbitration agreements were to designate NFA arbitration as an available option; and if the public were to be made aware of NFA's arbitration program. If all of these things could be accomplished, a single uniform arbitration code would exist for commodity dispute arbitration. A uniform arbitration code would minimize confusion because NFA, the exchanges, and the registrants (in their predispute arbitration agreements) would be referring to and using one set of arbitration rules and procedures.

If NFA arbitration is to reach its full potential, it will require substantial cooperation between the industry and CFTC. To ensure that commodity customers are aware of NFA's arbitration program, the industry and CFTC must educate and inform the public about the existence of the program and how it works. CFTC must also monitor the program to make certain that NFA is adhering to CFTC-approved rules and procedures.

CONCLUSIONS

The Congress and CFTC intended that the reparations program be an expeditious, easy-to-use, and inexpensive procedure for resolving customer claims. Although some parts of the reparations program have shown improvement since our last review, the program is still not meeting its objectives due to resource constraints, excessive delays and costs, and inefficient management practices. Nevertheless, because both the civil court litigation and arbitration alternatives to reparations pose problems of their own, we do not believe the reparations program should be abolished.

The complaints screening process, a problem area 4 years ago, is performing relatively well at present. CFTC has implemented the recommendations we made in 1978, and the section now screens complaints more quickly and its backlog has been largely eliminated.

The principal reasons for the slowness of the reparations program are found in the adjudication and appeals processes. Although adjudication and appeals processes have an inherent potential for delay, the reparations program is particularly slow because of resource constraints, increased workloads, and inefficient management practices. To expedite the adjudication process and alleviate the backlog in the hearings section, the chief ALJ needs to assign all complaints to the ALJs as soon as the complainant's filing fee is received. To help prevent excessive delays in adjudication, the chief ALJ needs to establish objective performance standards, delineating what is expected of each ALJ in terms of quality and quantity of work.

CFTC's reparations process is not easy for complainants to use, and as a result the program is not meeting a major congressional and agency objective. The majority of complainants we interviewed had difficulty understanding CFTC regulations. Complainants often found it necessary to contact CFTC to determine how they should proceed through the reparations process.

We found that CFTC currently collects and reports insufficient management information to enable it to monitor and evaluate the reparations program. This information is essential for CFTC to determine (1) where problems occur in the reparations process, (2) what improvements it should make, and (3) whether or not the reparations program is meeting congressional and agency objectives. If CFTC collected adequate information, it could inform the public about how long reparations procedures take, enabling customers to make informed decisions regarding the use of alternative forums.

CFTC has begun to collect and code detailed information concerning each reparations complaint so that it can be put onto a wordprocessor. This will enable CFTC to monitor the status of any particular complaint. However, using the system it has chosen, CFTC will not be able to quickly and easily generate necessary management information. CFTC's data needs to be computerized in a manner that quickly generates necessary management information. To ensure that this occurs, CFTC has included the reparations program in its planned overall study of ADP operations.

Commodity exchange arbitration programs that compel members to arbitrate with customers are currently subject, by Federal statute, to a dollar limitation of $15,000. In our estimation, this limit is too low, particularly in light of recent inflation and the substantial sums that are often involved in reparations claims. Like commodity exchange arbitration, the NFA's program will also be subject by Federal statute to a ceiling of $15,000. Again, we believe this limit is too low.

CFTC officials admit that they know little about the operation and performance of the various exchange arbitration programs. To overcome this deficiency and to ensure that exchange arbitration programs are credible and attractive alternatives to reparations and that they meet all legal requirements, CFTC needs to evaluate each exchange's arbitration program. This could be done, in some instances, as part of CFTC's exchange rule enforcement reviews.

CFTC has recently announced a proposed change in its rules that would require customers who have entered into predispute arbitration agreements with CFTC registrants to take their claims to arbitration rather than, as at present, being allowed to opt for CFTC's reparations program. One objective of these proposed rule changes is to relieve some of the pressure on CFTC's backlogged reparations program. While we believe that arbitration can and should be viewed as an alternative to reparations, we do not believe that CFTC's proposal, which limits access to reparations, should be adopted until CFTC can demonstrate that arbitration is a more plausible, trusted, and accepted alternative than it appears to be at present. An NFA-sponsored, industrywide arbitration program should go a long way toward overcoming some of the real and perceived problems of existing arbitration programs. However, to further improve and encourage commodity arbitration, CFTC needs to work with the industry, through NFA, to develop a uniform arbitration code.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

To expedite the adjudication process and prevent excessive delays, we recommend that the Chairman consult with the chief ALJ to:

--Assign all reparations complaints to the ALJs' dockets as soon as the complainants' filing fees have been received.

--Establish objective performance standards for ALJs that would explain what is expected in terms of performance and productivity.

So that all parties can better understand and use the reparations program, we recommend that the Chairman:

--Direct that the reparations rules be rewritten in plain English and simplified as much as possible.

To improve the monitoring and evaluation of the reparations program, we recommend that the Chairman initiate the following actions:

--Collect and analyze the detailed processing information needed to effectively manage the reparations program and assess its performance.

--Report pertinent program statistics to the Congress on a regular basis (for example, in its annual report or during oversight hearings) to enable it to make informed judgments concerning the performance and future of the reparations program.

--Computerize all management information concerning the program.

To make arbitration a more attractive and effective alternative to reparations, we recommend that the Chairman direct the staff to:

--Perform an evaluation of all exchange arbitration programs to determine whether they are meeting all legal requirements.

--Work with industry officials and NFA to encourage the use of the association as an arbitration forum.

RECOMMENDATIONS TO THE CONGRESS 1/

To increase the effectiveness of exchange arbitration programs, the Congress should raise the dollar limitation on the amount customers can compel exchange members to arbitrate from $15,000 to $25,000. The Congress should authorize CFTC to periodically adjust this dollar limitation as warranted by inflation and to reflect the size of claims submitted to the reparations program.

1/Legislative language to authorize these recommendations is included in app. XII.

To increase the likelihood that the NFA's arbitration program will be effective, the Congress should raise the dollar limitation on the amount that customers will be able to compel Association members to arbitrate from $15,000 to $25,000. The Congress should authorize CFTC to periodically adjust this dollar limitation as warranted by inflation and to reflect the size of claims submitted to the reparations program.

AGENCY COMMENTS AND OUR EVALUATION

CFTC commented in some detail on our discussion and analysis of the reparations program and on actions it has taken concerning exchange arbitration programs. Based on these comments we have made changes to our report as appropriate. CFTC's comments are presented in their entirety in appendix XV.

CFTC disagreed with our attribution of the slowness of the reparations process to the fact that (1) the chief ALJ does not immediately assign complaints to the presiding officers and that (2) the agency has not developed any explicit performance standards which would encourage the presiding officers to maintain high productivity. CFTC stated that it is unfair to blame the presiding officers for a slowdown since each has an extensive docket and the chief ALJ reviews their caseload and production.

We have updated the data in this chapter to show the increased number of complaints on the presiding officers' dockets as of February 1982 and the decreased number of unassigned complaints in the hearings section as of March 1982. While these developments are encouraging, the chief ALJ is still not immediately assigning all complaints after the adjudication process begins--an action which would encourage settlement and thereby help to reduce the current backlog.

CFTC asked us to "reconsider" our statement that the agency has not designated qualified staff members to answer the legal and procedural questions of parties to reparations cases. With respect to cases that have been assigned to presiding officers' dockets, CFTC stated that law clerks have been available to assist the parties. With respect to cases that have yet to be assigned to the presiding officers' dockets, CFTC stated that the hearing clerk can provide status information. While law clerks have always been available to assist the parties in answering legal and procedural questions, only a few presiding officers have conveyed this information to the parties in prehearing orders. However, we have deleted our recommendation in this area because in December 1981 (after we completed our audit work) the hearings section began to send out correspondence designating a paralegal specialist to whom parties should address their questions. We believe that the program will be easier to use as a result of this action.

CFTC commented that we did not consider the large number of cases stayed by the Commission or cases stayed by the courts due to bankruptcy and receivership. CFTC also stated that the statistics we presented did not take into account the qualitative factor; such as that some complaints involve complex issues which often require considerable study and analysis to resolve. Furthermore, CFTC stated that even though these complex questions may take time to decide initially, the decisions will save time in the long run by clarifying legal and marketplace issues. 1/ In line with CFTC's comments, we revised our statistics to show the number of complaints that involved firms in bankruptcy and receivership. Also, in order to give the reader a better understanding of the complexity of some reparations cases, we revised our introductory paragraph to include examples of the types of disputes litigated in reparations. Further, in the context of a discussion of performance standards, we explicitly recognize the complexity involved in some complaints.

CFTC stated that it found discrepancies between our statistics and its own relating to cases pending before the Commission. It concluded that this was attributable to our use of the term disposition to refer only to Commission orders denying review or to full Commission opinions. CFTC stated that there are other possible types of Commission orders to dispose of cases. CFTC's statistics show 91 cases pending at the end of 1981. We have expanded our definition of Commission and opinions section dispositions to include miscellaneous actions. CFTC provided us with additional statistics to support its position on the number of cases that were pending before the Commission at the end of fiscal year 1981. We have revised the chart on page 179 accordingly.

CFTC commented that we did not recognize that it has received, reviewed, and approved complete arbitration rule packages from all 11 exchanges currently designated as contract markets. Further, CFTC stated that rule enforcement reviews may be appropriate but are not essential before changing its current arbitration rules. CFTC added that rule enforcement reviews are not the primary means by which the Commission maintains its awareness of how exchange arbitration responsibilities are performed. The agency also noted that before it proposed any amendments to the current arbitration rules, it contacted several exchanges in order to become more familiar with exchange arbitration systems, documentation, and statistics. CFTC stated that it will scrutinize all comments it receives on the proposed arbitration rule changes and that these comments may also guide the development of NFA's arbitration program.

1/CFTC decisions will save time in the long run by clarifying legal and marketplace issues only if the Commission issues a final decision, thus setting legal precedent.

We have expanded our discussion of commodity exchange arbitration to reflect the fact that CFTC received, reviewed, and approved complete arbitration rule packages from all exchanges. However, in our view the CFTC rule approval process does not assure that exchange programs are currently working as intended. CFTC provided us with a staff document discussing its proposed arbitration rules. However, this document reports statistics on only five commodity exchange arbitration programs. Moreover, CFTC uses words such as "preliminary" and "initial" when describing its own analysis and discussions with industry officials. While we believe that a comprehensive evaluation of commodity exchange arbitration programs is still needed, we agree with CFTC that it does not necessarily have to be accomplished in the context of a rule enforcement review.

Finally, we are confident that CFTC staff will scrutinize and take into consideration the comments it receives on any proposed arbitration rules. We also agree that these comments will be helpful in guiding the development of an arbitration system by NFA.

EXCHANGE COMMENTS AND OUR EVALUATION

Chicago Board of Trade (CBOT)

The exchange commented on our discussion of commodity exchange arbitration. 1/ CBOT stated that neither the act nor CFTC regulations compels an exchange to require its members to arbitrate a dispute. The exchange further stated that the United States District Court for the Northern District of Illinois has ruled in favor of this position.

We have revised our discussion of commodity exchange arbitration to reflect the fact that CFTC has interpreted the act to require exchange members to arbitrate claims less than $15,000. In addition, we have added a footnote on the status of this litigation.

CBOT also explained why it was not offering customers the option of selecting a mixed panel. The exchange stated that on January 20, 1981, it submitted to CFTC a new, amended package of arbitration rules. While awaiting CFTC approval of the entire rule package, CBOT stated that it did not implement any portion of these rules. The exchange added that it had notified CFTC of its intentions. CBOT stated that CFTC approved its amended arbitration rules on December 9, 1981, and that the

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1/The exchange's comments are presented in their entirety in app. XVI.

rules were put into effect on January 1, 1982. The fact that the Chicago Board of Trade is now offering customers the mixed panel option is encouraging.

OTHER COMMENTS AND OUR EVALUATION

National Futures Association

NFA provided us comments which outlined legislative changes it has recommended to the Congress. [1] NFA proposed that the Congress authorize the association's arbitration program to take the place of CFTC's reparations program. In addition, NFA recommended that the Congress remove the $15,000 limitation that currently applies to arbitration proceedings before a national futures association and authorize commodity exchanges to delegate to such an association the exchanges' responsibility to provide arbitration.

We believe that arbitration can be an attractive alternative to the reparations program and that NFA's program offers promise in this respect. However, NFA's arbitration program has not yet begun. In our view, NFA's program should not take the place of reparations until it has been in operation for a period of time and has demonstrated that it has the ability to supersede CFTC's reparations program.

Department of Justice

The Department of Justice provided detailed comments on our draft report's discussion of NFA. See page 74 for our response to those comments.

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[1] NFA's comments are presented in their entirety in app. XVI.

CHAPTER 9

CFTC CAN MORE EFFECTIVELY MANAGE ITS ADP RESOURCES

CFTC is responsible for examining and supervising an industry that generates millions of complex transactions each year and has grown rapidly in the last decade. Consequently, the agency must be able to capture and analyze large amounts of data. However, CFTC's ADP systems have become outdated while its need for them has grown, and weaknesses in ADP management have contributed to serious deficiencies in software development and maintenance and in computer operations.

CFTC has launched a program to define its future ADP needs and to identify the data processing capability needed to satisfy those needs. It has also begun a program to enhance its ADP capability in high-priority areas. To enable CFTC to build on the program it has initiated, we suggest several planning and management actions that it can take to further improve management of its ADP resources.

DESCRIPTION OF ADP SYSTEMS AND RESOURCES

In fiscal year 1981, CFTC obligated about $1 million, or 5.5 percent of its budget, for ADP. The agency estimates that it will obligate about $1.1 million for ADP operations and $400,000 for ADP enhancement in fiscal year 1982--about 7.5 percent of the agency's budget. In addition, it has assigned about $410,000 in unexpended fiscal year 1979 funds that were obligated under an interagency agreement with General Services Administration (GSA) to the Environmental Protection Agency for computer and technical support services.

CFTC's Executive Director is responsible for the agency's information resources management. The Director of ADP Services at headquarters in Washington, D.C., is responsible for CFTC-wide computer systems support. In Washington, CFTC operates a minicomputer for its administrative applications and two microcomputer graphics systems for research support. Recently, CFTC augmented its in-house capability with contract computer services to provide computer and technical support services for new program development.

CFTC's principal computer and staff resources are located at its data center in Chicago. Under the supervision of the director, central region ADP, the center provides operations and systems support primarily for CFTC's market surveillance, research, and registration programs. The center houses CFTC's main computer, an NCR 8555 medium-size business computer system. It is also responsible for two minicomputer data entry and transmission systems that are located in Chicago and New York City. As of May 1, 1982, CFTC had all of its 23 authorized ADP positions filled. In addition to the Director and the manager of its Chicago data center, CFTC had eight programers and analysts to provide software development, programing, and technical support (four are located in Washington); four computer operations technicians; eight data transcribers (four are located in New York); and one clerk-typist.

The heart of CFTC's ADP capability is its application software, the collection of computer programs that maintain data files and produce reports or other products in support of particular mission objectives. CFTC's application software systems, which are generally processed in Chicago, fall under four broad categories: market surveillance, research, registration, and administration. Briefly, these systems function as follows:

--The market surveillance application systems build data files of information collected from exchanges, FCMs, and traders relating to volume of trading, open interest, pricing, and position information on large traders. The reports generated by the systems support the detection and prevention of price manipulation and the enforcement of speculative limits. (See ch. 4.)

--The research application systems produce reports that facilitate surveillance and analysis of specific markets or market variables using current and historical data. These reports support the conduct of trade practice investigations and rule enforcement activities and respond to research needs of the Congress, other Government agencies, and educational institutions. (See ch. 4.)

--The registration application systems establish and maintain CFTC's registration data files, which include several categories of registrants, such as FCMs, FBs, and APs. The systems' reports and other products support, among other things, registration processing, registration renewal notification, and registrant status reporting. (See ch. 5.)

--The administrative application systems, which are processed at headquarters, enter, update, and maintain data for administrative support of payroll, position management, financial management, budget, and physical inventory.

OUTDATED ADP SYSTEMS HAVE NOT EFFECTIVELY SUPPORTED CFTC PROGRAMS

CFTC's principal application software systems for market surveillance, research, and registration are 10 years old. They consist of several hundred programs that resulted from a 1969 study entitled "A Commodity Exchange Authority Management Improvement Project Study" and that CFTC inherited when it succeeded the Commodity Exchange Authority in 1975. The director of CFTC's Chicago data center told us that these systems are poorly documented and have proven difficult to maintain or improve. [1] They remain substantially unchanged even though CFTC's regulatory responsibilities were greatly expanded beyond those of its predecessor. The recently resigned Director of ADP and the present manager of the data center both characterized these systems as outdated and unsalvageable.

Specific problems with CFTC's ADP program are discussed elsewhere in this report. In chapter 4 (market surveillance) and chapter 5 (registration), we point out that CFTC's ADP systems do not adequately support important CFTC regulatory programs. In addition, in chapter 8 we discuss CFTC's need to design and implement a reparations management information system. These deficiencies are widely acknowledged within CFTC and it has recently begun a program to replace or improve the deficient application and hardware systems.

In 1981 CFTC obtained a modern NCR 8555 computer and improved NCR 658 disk drives as an interim measure to upgrade its central computer system in Chicago. The new hardware was obtained primarily to reduce equipment failures and has not brought recognizable improvements in ADP service because it is emulating the system it replaced and is using the same software that has been in use for more than a decade. To improve its ADP service CFTC must design and implement new or improved application systems, tasks which it has thus far been unable to do. CFTC has not established an effective ADP planning structure and has not effectively carried out essential activities such as organizing, directing, and controlling ADP. These weaknesses were major factors in the slow progress CFTC has made in its ADP program.

CFTC CAN ESTABLISH AN EFFECTIVE ADP PLANNING STRUCTURE

A comprehensive planning process is essential for effective information resources management. Since ADP resources are limited and ADP decisions, priorities, and resource commitments have long-term impact, available resources must be effectively and efficiently applied. This requires a comprehensive plan that identifies overall agency ADP requirements, develops a strategy for satisfying those requirements, and sets forth priorities for system development and implementation.

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[1] As our report entitled "Federal Agencies' Maintenance of Computer Programs: Expensive and Undermanaged" (AFMD-81-25, Feb. 26, 1981) points out, outmoded and poorly documented software is a serious and growing problem throughout Government and business. Poorly documented software, as it is revised or updated, soon becomes extremely difficult to work with and understand.

Previous ADP studies have established the groundwork for software planning

Several studies have dealt with CFTC's information needs, but these studies did not produce a comprehensive plan. Early, pre-CFTC studies, such as the 1974 Joint U.S. Department of Agriculture-Industry Report on Futures Trading Data Systems, focused primarily on CFTC's large-trader reporting, market surveillance, and trade practice investigation functions. These studies suggested various ADP system improvements and focused on technical application software requirements rather than the systematic ADP management improvements that would have improved chances for successful software development. The need for overall planning, however, was more evident in the two major studies that followed CFTC's authorization in 1975.

In May 1977 Arthur Young and Company completed a study entitled "CFTC Overall Information System Design" at a total contract cost of $30,000. The second major study was a joint GSA-CFTC study of CFTC information system requirements. When GSA suspended active involvement in the project in 1980, CFTC had invested about $40,000 of a total of $450,000 it had set aside for computer contract services in the joint project.

The Arthur Young study was initiated in 1976, shortly after CFTC's authorization. The former Executive Director told us that the 1974 and 1975 amendments to the Commodity Exchange Act and industry growth had clearly outmoded the existing ADP systems. The study was an attempt to define system improvements needed to address those changes.

Arthur Young analyzed CFTC's information requirements and ADP system capabilities. Arthur Young's report presented a system concept whereby CFTC would integrate its functional systems as well as design improvements to individual systems. It recommended that the conceptual system design be followed by a nine-step implementation, test, and evaluation process that included detailed system design. The study identified four priorities for CFTC: to design systems for market surveillance, for registration, and for trade practice investigations and to develop a long-range ADP resources plan.

CFTC also conducted an in-house evaluation of information system requirements and workload in September 1979. The report, entitled "Study of Information System Requirements," became the basis for a joint CFTC-GSA effort in 1979 to design new application systems and to competitively replace CFTC's central computer.

By entering into an interagency agreement with GSA, CFTC obtained the technical expertise necessary to guide it through the Federal ADP procurement process. Under the agreement, CFTC deposited $450,000 with GSA to be used by mutual agreement to reimburse GSA for its services as well as procure outside design services or hardware. The first step was to be a study of CFTC's broad information requirements.

The CFTC-GSA study's objective to develop an overall system concept, however, was not achieved. The joint effort produced a detailed requirements analysis of one application system, registration, and a partial analysis of another, market surveillance. The effort stalled when CFTC decided to upgrade its existing hardware system and delay the system's replacement. The completed CFTC-GSA detailed requirements analysis of the registration function, like the Arthur Young study, was never acted on. Instead, CFTC began another study of registration requirements which in turn was abandoned a few months later when CFTC changed its ADP priorities. Consequently, after repeated study attempts, CFTC's application systems remained unchanged. The Director of ADP told us that the Arthur Young study and others are being used in CFTC's present effort to improve its ADP program.

CFTC needs to develop key planning elements

We have discussed the elements of good ADP planning in our evaluation guide entitled "Questions Designed to Aid Managers and Auditors in Assessing the ADP Planning Process" (draft, Aug. 1979). As noted in the guide, there is no one best way to organize and implement information resource planning and integrate it into an agency's activities, but a planning structure should

- --require participation by the several levels and interests of management;
- --establish mission requirements, ADP strategy, and ADP system goals and objectives;
- --identify the specific actions to be accomplished;
- --budget financial, personnel, and ADP resources;
- --measure and compare actual accomplishments with expected performance; and
- --require progress reporting that informs appropriate managers of the status of planned actions.

Although several years have passed since the 1977 Arthur Young study emphasized the need for comprehensive ADP planning, CFTC still does not have an overall ADP plan. The comprehensive planning elements mentioned above continue to be virtually nonexistent. In November 1981 the present Director of ADP told us that a comprehensive ADP plan still did not exist, which hampered efforts to resolve CFTC's short-range ADP problems and to develop a coherent plan of action.

Recognizing the importance of comprehensive planning, CFTC informed us that it has entered into an agreement with the Environmental Protection Agency in December 1981 that will result in a comprehensive plan and a design for a planning process.

More information on computer usage would facilitate accurate computer resource planning

A critical aspect of comprehensive ADP planning is computer resource planning that includes equipment, software, and personnel. To properly plan for computer resources, ADP management must be aware of how it is using resources and how well it is satisfying user requirements. Specifically, ADP managers must have information concerning workload, including growth trends, present resource demands, and likely growth in the future, as well as information concerning ADP performance in satisfying user requirements.

CFTC does not presently have adequate information to evaluate the use of its computer systems. Typically, information on how a computer and other devices are used and how well is compiled by the computer's operating system software that monitors and controls its operation. We found that the data available for evaluating CFTC's computer configuration is very limited. During our visit to the Chicago center, we tried to analyze how CFTC was using its system. CFTC's operating software does not measure central processing unit usage or compile other information that is useful in evaluating how efficiently the computer is being used. The manager of the data center agreed that he needed resource utilization information. He told us that he did not have the staff to write the necessary specialized programs and that CFTC had made no decision to upgrade the computer's operating system to one which would provide more resource accounting information. The Director of ADP, however, told us that an upgrade of the operating software was being considered to modernize certain aspects of CFTC's computer hardware.

CFTC's job of planning for its present and future ADP needs is very difficult without resource accounting information. Estimates of its current needs and predictions about its future needs are guesses at best.

CFTC NEEDS AN EFFECTIVE ADP MANAGEMENT STRUCTURE

While comprehensive planning is a positive step, several additional management improvements need to be taken to complement planning. Weaknesses in CFTC's ADP management structure have contributed to serious deficiencies in both software development and maintenance and in computer operations.

CFTC can improve management of software development projects

We found that CFTC did not have clear management standards to guide software development projects. An examination of three recent software development projects, discussed below, demonstrates a need for CFTC to improve its project management approach. The projects experienced serious delays or were not completed at all. In addition, user requirements were inadequately defined. These problems compound CFTC's already serious problem of coping with outdated and undocumented software. A standard approach, applied agencywide, would improve CFTC's project control.

Why software management is important

Effective software management is important for two reasons:

- --Software development costs are high; therefore, it is necessary to achieve the desired result at the least possible costs.
- --An application system's life spans several years; therefore, it is necessary to ensure that modification and updating can be done at minimal cost.

Managing software development projects effectively is often difficult because they are complex and especially prone to unforeseen problems and delays.

Effective management of software development projects has become an important part of the ADP manager's job. In contrast to the early days of computers, software now accounts for the bulk of ADP costs. In our report entitled "Wider Use of Better Computer Software Technology Can Improve Management Control and Reduce Costs" (FGMSD-80-38, Apr. 29, 1980), we noted that recent studies project that software costs will exceed 90 percent of total ADP costs by 1985. These costs are incurred throughout a software system's life cycle, which averages about 5 years, and encompass all actions from application conception to retirement.

A standard approach, with well-defined, management-action-oriented phases, is an effective way of managing software development projects. 1/ These phases should be standardized throughout the agency and retain a relatively consistent, product-oriented definition from project to project. One benefit of a standard approach is that management control is an accepted part of the project. Intermediate products and milestones are generally defined, and the degree of management and staff participation is commonly understood. With good management control, project problems are more likely to be identified promptly and satisfactorily resolved. CFTC has been generally unsuccessful in its software development efforts, and poor project management was a major factor.

CFTC has not effectively managed software development projects

Recent CFTC software development projects generally produced unsatisfactory results even though a project management system was installed at the Chicago data center. Two projects--registration and reparations--were not managed under the system at all. The registration project was not completed, and the reparations management information system will not provide needed information. A third project, large-trader reporting, was managed under the system, but the system was applied ineffectively and was of little benefit. That project, months behind schedule, was ultimately subdivided so that the most important part could be completed when needed. (The registration project is discussed in ch. 5, the large-trader reporting project is discussed in ch. 4, and the reparations management information system project is discussed in ch. 8.)

In general, the project management system has been used only for documenting requests for software changes and special reports. However, it has more formal features, such as the requirement for a system development plan, that could be used for evaluating and managing more complex projects. The former ADP Director told us that he viewed the system as primarily relevant to the internal management of the data center. Consequently, he reviewed system requests to get a general overview of what the Chicago center was working on and to resolve any priority conflicts, but he did not review in detail how the projects were staffed or managed.

Even though CFTC's project management system encompasses many of the criteria for a development project management system, it is designed so that it cannot be used outside the ADP department without the support and oversight of an ADP steering

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1/For further discussion of software project management, see "Government-Wide Guidelines and Management Assistance Center Needed to Improve ADP Systems Development" (AFMD-81-20, Feb. 20, 1981).

committee. As discussed later, CFTC has been without an active steering committee since mid-1980. Consequently, the system was not implemented agencywide and therefore did not provide feedback to top management on project progress. We believe that implementing the project management system agencywide and imposing the system on all in-house application development projects would greatly increase its effectiveness.

Software deficiencies will be a persistent problem for CFTC

Software development and maintenance problems will probably persist for CFTC and are made worse by limited staffing. The systems development and programing staff, which has experienced a 100-percent turnover since December 1979, could not perform both software maintenance and software development. The staff, which increased from four in August 1981 to eight in February 1982, was faced with trying to understand and document the hundreds of poorly written and undocumented computer programs it inherited. Maintaining these programs became extremely difficult and costly due to the large number of changes that have been required to provide necessary enhancements to the existing software systems. Furthermore, CFTC is forecasting that fiscal year 1982 maintenance requirements will increase by as much as 20 percent over those of fiscal year 1981. Therefore, maintenance can be expected to continue to consume a substantial share of CFTC's systems development and programing staff resources.

Further aggravating the demands on CFTC staff time are the need to convert operating system software and files to accommodate the more modern disk subsystem leased in 1981 and the need to upgrade the operating software for data entry minicomputers. Between July 1981 and January 1982, CFTC did not have a system software specialist to perform these tasks. Although a systems programer was hired in February 1982, staff supporting the applications programing efforts had to be used for over a year, further reducing maintenance and systems development capability during that time.

CFTC also faces a substantial demand for new systems development. During our field work, we became aware of several pressing software development needs that the ADP staff could not meet. These included additional requirements associated with exchange-traded options, registration, and new commodity contracts that could require software enhancements or additions to the current system of programs. Although the recent hiring of three additional computer specialists in Washington will help, it is not a total solution.

The Director of ADP told us in January 1982 that he has discovered an enormous potential demand for ADP support in CFTC's regulatory programs and that new requirements are surfacing continually. The Washington staff had begun to address these development needs with contractor assistance and had initiated the studies necessary to define CFTC's long-term ADP needs. The Chicago staff, however, will probably continue to be preoccupied with software maintenance and related problems until the old software has been replaced. The Director of ADP told us that in the short run new development projects will have to be ranked in priority order unless he receives a substantial increase in staff or contract resources.

CFTC can strengthen controls in its central facility

CFTC's central computer facility's operations are seriously overburdened. Hampered by poorly written, undocumented, and unreliable software, the staff can barely complete the center's daily workload. Successful system operation depends directly on the computer operators' first-hand knowledge of how the undocumented software systems are executed. Operations staff turnover, if it occurs, and particularly the loss of expertise which it would represent, can have, under these circumstances, especially debilitating consequences. In addition, CFTC cannot determine if program controls to prevent erroneous program execution are adequate and physical data security is questionable. In short, the Chicago computer center is the "Achilles' Heel" of ADP support for CFTC's mission.

CFTC's central computer system, about 10 years old, was recently upgraded to reduce hardware failures. The original computer, an NCR Century 200, was leased from January 1971 until January 1981. At that time, CFTC began to replace the computer and associated disk drives with a modern NCR 8555 computer and NCR 658 disk drives under an interim delegation of procurement authority from GSA. This was a technological update to restore dependable operation, and CFTC is obligated by its agreement with GSA to competitively replace the computer system by May 7, 1983. Detailed procurement actions related to the system are included in appendix X.

CFTC's computer operations are precarious because, as discussed previously, they depend on software that is generally unreliable. For example, about 8,000 records were inadvertently deleted from CFTC's registration history files in early 1981. This data loss was not detected for several weeks and then only because it was so massive as to be physically noticeable in the reduced volume of microfiche documents produced. Although the file was subsequently reconstructed, at the cost of considerable staff effort, the system and programing manager told us that his group was unable to determine the cause.

In another instance, one of the large-trader reporting programs was producing a report that contained numerous errors. According to a May 7, 1981, memorandum from the director of the market surveillance section that described the problem, more than half of the entries in one portion of the report were erroneous. According to the memorandum, the erroneous listings consumed staff resources unnecessarily because the staff was required to verify each entry of the report in the section's hard copy files.

CFTC's computer operations are also precarious because they depend to an inordinate degree on the experience and ingenuity of computer room personnel. We spent several days in Chicago observing CFTC's computer room operations and interviewing operations, programing, and managerial staff. We found that successful execution of CFTC's computer application systems depends heavily on undocumented operator experience. The operators told us that an individual who did not have the prior experience would probably not be able to run the jobs. Lack of adequate operator instructions is a serious problem because mistakes by the operator will cause incorrect or unsuccessful execution of the computer programs, resulting in inaccurate data in output products.

CFTC's risk of program interruption or erroneous execution is increased unacceptably in two additional respects: (1) CFTC has inadequate staff to assure continuous operations and (2) it has inadequate program controls to detect mistakes. The operations staff consists of an ADP manager, one computer operations supervisor, and three computer operators. The computer operations supervisor and two operators share the functions of computer operator, tape librarian, data control, and workload control, and the remaining operator is detailed to staff the second shift. We were told that when one or more of the operations staff is gone due to vacation or sickness, some functions are not performed.

There is little or no separation of duties at the computer center in Chicago. Because of the small staff, each staff member must know the others' duties and be able to perform them in their absence. Under normal conditions the tape librarian, the computer operator, and the computer room supervisor would perform their separate duties. But, as we observed at the center, one person at times must perform the duties of all three persons. Not only is the risk of error increased under such circumstances, but checks and balances that are important to the security and integrity of computer operations are absent.

Because CFTC has not analyzed or documented its software, it cannot assure that program controls to protect against mistakes are adequate. In fact, such mistakes can occur in some important programs, as the following example shows. CFTC's large-trader reporting system is run twice each day, once using Chicago input and output files and once using New York input and output files. The operator mounts the files and selects the proper run option. The manager, systems and programing, told us that he intentionally tried to run a large-trader reporting system program that was set up to use New York input data with Chicago input data and the program began to execute without detecting that the input and output files were mismatched. He said that erroneous alteration of the output files could have occurred had the "error" been unintentional and gone undetected. Such possibilities increase the potential adverse effects of operator dependence and inadequate staffing. Any loss in the CFTC ADP staff in Chicago would have a severe impact on its ability to continue to support its mission.

Physical security and backup are also problems. The computer center does not have a separate tape library. The tape library is in the computer room. Backup master files are kept onsite. The only backup computer available to CFTC is located in Rolling Meadows, Illinois. According to the director of the Chicago data center, a dry run of CFTC operations has never been made there, and a question exists about whether the site has a compatible computer configuration. Thus, severe damage to the computer system caused by a manmade or natural disaster would severely handicap CFTC's operation.

CFTC's top management control over the ADP program can be strengthened

CFTC's ADP problems stem primarily from a long-standing lack of appreciation by management for the complexities of providing ADP service and the attention necessary to manage it effectively. The conditions we have discussed--the incomplete ADP planning structure, the weaknesses in project management, and the precarious computer operations--all point to weaknesses in basic management activities. In addition, organizational weaknesses left managerial responsibility for these activities undefined and diffused. The Executive Director told us that when she took office in July 1981 she found that CFTC's ADP program was not being managed, in a meaningful sense, by anyone.

The best way for CFTC to provide effective leadership and direction to its ADP program is to build on the recent actions it has taken to consolidate and improve management of all information resources. In particular, on August 5, 1981, CFTC's Chairman designated the agency's Executive Director as the senior official responsible for information resources management. The Executive Director, in turn, has taken the following actions:

--Consolidated the functions of ADP Director and Chief, ADP Services.

--Hired a new Director of ADP Services and assigned him broad responsibility for ADP planning and management.

--Taken steps to reestablish an executive steering committee for ADP.

--Entered into an agreement to obtain computer and technical support services for comprehensive planning and new system development.

In our opinion, these are all positive steps that can result in significant improvements in ADP management. Ultimate success, however, will depend on continued strong leadership from the Executive Director. Continuation of the steering committee and increased internal audit involvement should be particularly helpful in providing that leadership.

An executive steering committee aids in providing leadership and direction

Use of an executive steering committee is an accepted way for top management to provide leadership and direction and to assure efficient and effective use of information resources. CFTC established a steering committee in 1979, but it functioned only briefly until mid-1980. Although there is evidence that the steering committee initially functioned to set ADP priorities and address broad policy issues, we believe its brief existence demonstrates that continuity deserves special consideration in CFTC's efforts to reestablish the committee.

The Executive Director told us in October 1981 that an ADP steering committee had been reestablished. We believe that its importance cannot be overemphasized. Chaired by a representative of top management, such as the senior level official responsible for information resources management, the committee brings together at a senior level, information resource managers, users, and administrators. It functions to advise management in establishing information resource policies, directing planning, evaluating resource needs, and overseeing resource allocation and use. The steering committee needs to have a formal charter that sets forth the committee's composition and responsibilities and makes clear its permanence. The charter should also make clear the overall authority and responsibility of the Executive Director as the senior official responsible for information resources management. In December 1981, the Director of ADP told us that he had not been informed of his role on the committee or of the committee's functions. Since that time discussions about the committee's functions have taken place, although as of May 1, 1982, a formal charter had not been published and the committee had not been reactivated.

Increased use of internal audit could improve system controls

Internal auditing is another important element of information resources management. Internal auditing is an independent appraisal of how well organizational activities are carried out and can be particularly effective in assessing control and accountability in ADP systems and operations. It complements other elements of top management control.

CFTC relies on computer-based information systems for the effective performance of important regulatory functions. As our pamphlet entitled "Standards for Audit of Governmental Organizations, Programs, Activities and Functions" points out, it is possible to develop a data processing system with such poor controls that neither the manager nor the auditor can rely on its integrity. Because of this, it is important that auditors contribute to the design and development of these systems as well as assess the quality of their output and their effectiveness in supporting the agency's mission. 1/

To date CFTC's internal audit staff has had a very limited role in ADP. CFTC's director of audit and evaluation told us that his staff has made three ADP studies, all of which focused on narrow payroll system issues, and has had no role in ADP application software design or testing. He said that the scope of his duties are defined by the Executive Director and that internal audit involvement in ADP was limited by limited staff expertise and the high priority of other audit activity.

We believe that a degree of internal audit coverage commensurate with ADP's importance to CFTC's regulatory activities is essential. Developing staff expertise is a gradual process. As our previously cited report on internal auditing points out, expertise can be achieved in several ways, such as in-house training programs and external training at other Federal agencies. In today's computer environment, we believe that all auditors should have a basic level of computer knowledge.

The need for CFTC to provide for internal audit coverage is illustrated by the informal procedures for using the administrative application software systems. We discussed these systems with the four CFTC staff members who use them most often. These staff members perform such important functions as: (1) travel advance accounting and petty cash, (2) travel voucher accounting, (3) miscellaneous payments and payroll, and (4) general ledger accounting. Our discussions revealed that CFTC has not established formal job procedures or system user procedures for these functions. The staff members defined their jobs themselves and exercised their own initiative and discretion in learning how the various ADP reports should be used.

The Cate Corporation, which reviewed CFTC's administrative systems at CFTC's request, found significant control problems in CFTC's automated accounting system. In a November 1981 report,

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1/The internal auditor's role in assessing computer-based information systems and methods of developing a computer audit capability is discussed in detail in our report entitled "Federal Agencies Still Need to Develop Greater Computer Audit Capabilities" (AFMD-82-7, Oct. 16, 1981).

Cate concluded that the system should be replaced. CFTC's Director, Operations and Budget, said that CFTC is currently studying the report's conclusions and recommendations. He also said that he had recognized the existence of internal control problems for some time but that limited staffing required that he give priority to implementation of an object class budget system and day-to-day budget management.

OMB Circular A-123, October 28, 1981, emphasizes the need to establish and maintain an effective internal control system. It requires that each agency issue an internal control directive and vulnerability assessment plan 1/ by March 31, 1982, and that it perform the assessments by December 31, 1982. It assigns the senior audit official specific responsibility for reviewing internal control documentation, systems, and compliance and for performing internal audits. CFTC's Executive Director agreed that the internal audit staff could contribute to the agency's effort to make its ADP program responsive to its needs. 2/

CONCLUSIONS

ADP management could be vastly improved if problems identified by both CFTC and us were corrected. A more responsive ADP program will increase CFTC's ability to keep apace of market growth, enhance current applications, and develop new applications to support its mission. Its current ADP support, by all accounts, is clearly not adequate and needs to be either redesigned to make better use of existing capability, expanded to add new capability, or some combination of the two. Solving these problems requires decisions that are complex and involve difficult trade-offs.

CFTC is beginning the comprehensive planning that is so vital to effective ADP management and to design a formal ADP planning process. Past planning weaknesses adversely affected efforts to upgrade its central computer system and improve its application software systems. Formal comprehensive planning will make CFTC's efforts to exercise strong management direction in restructuring its ADP program more effective.

Effective software development project management, like sound comprehensive planning, is vital to a strong and efficient ADP program. Because they are costly and inherently difficult to

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1/A vulnerability assessment is a review of the susceptibility of an agency or program to loss or unauthorized use of resources, errors in reports and information, illegal or unethical acts, and/or adverse or unfavorable public opinion.

2/CFTC issued the plan required by OMB Circular A-123 on Mar. 31, 1982, and the directive on Apr. 12, 1982.

manage, software projects especially benefit from a standard management approach that includes adequate planning, documentation, and control. The three recent CFTC projects we reviewed either were not completed or exhibited serious problems.

Each of the ADP management activities we examined in detail--comprehensive ADP planning, software development project management, and computer center operations--exhibited weaknesses that need to be corrected.

Continued strong leadership and direction are needed for CFTC's ADP program. The Executive Director has begun to move in this direction by reestablishing an executive ADP steering committee. We believe that the newly organized steering committee is likely to be most effective if it is given a formal charter that establishes it as a standing committee.

Deciding upon the source and type of computer equipment that will best support CFTC's near and long-term ADP needs will require making a number of preliminary studies, which CFTC has already begun. Making these studies and carrying out CFTC's other duties may call for more staff than CFTC has. Additional permanent, temporary, and contract staff may be necessary.

CFTC has begun to explore and evaluate its alternatives by undertaking the studies outlined in Federal ADP procurement guidance. At the same time, we are suggesting ways that the agency can restructure and formalize its ADP program management.

RECOMMENDATIONS TO THE CHAIRMAN, CFTC

We recommend that the Chairman, CFTC, direct the agency's Executive Director to:

--Establish a comprehensive information resource management planning process.

--Establish a standard agencywide project management process that will be applicable to each major software development project. The process should set standards for project planning and documentation and establish minimum review and control procedures.

--Emphasize the importance of strong and effective ADP management.

--Present for Commission consideration and approval a charter establishing the newly organized executive steering committee as a standing CFTC committee and setting forth clearly its responsibilities and authority.

AGENCY COMMENTS AND OUR EVALUATION

CFTC stated that action regarding the steering committee's reestablishment had been deferred until the new ADP team was on hand and had charted a new direction. 1/

We disagree with the decision to delay the reestablishment of the ADP steering committee. The purpose of this steering committee is not to direct staff but to advise higher level management on overall ADP policy questions, on ADP requirements, and on resource needs. The Executive Director of CFTC, to whom this committee's advice would be directed, is in place, as is the agency's new ADP team. The steering committee's input is therefore needed now. In fact, its input is most important at the earlier, formative stages of charting new ADP directions.

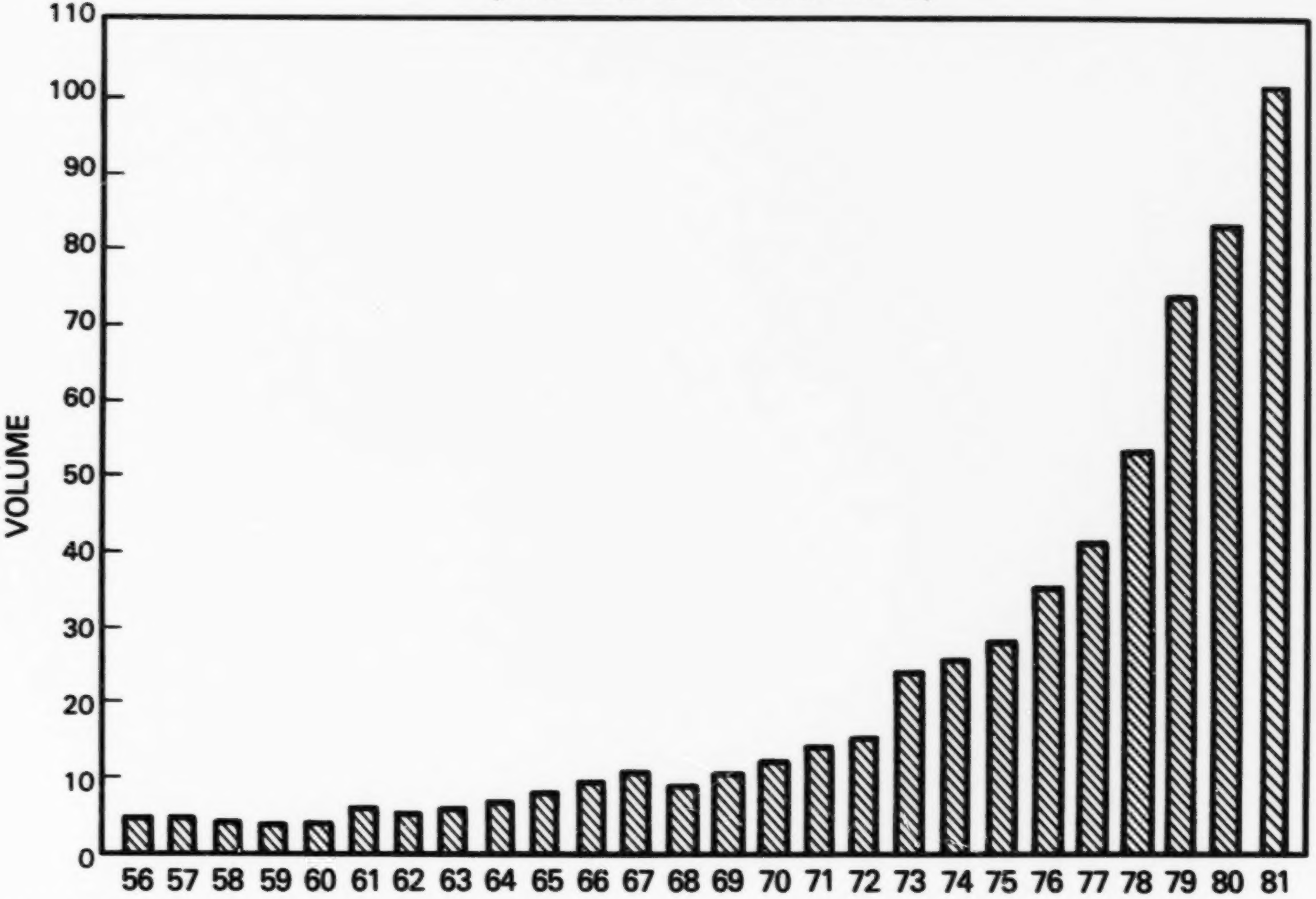
1/CFTC's comments are presented in their entirety in app. XV.

APPENDIX I

APPENDIX I

FUTURES TRADING ON THE U.S. EXCHANGES
VOLUME OF TRADING, FISCAL YEARS 1956-81

(IN MILLIONS OF CONTRACTS)



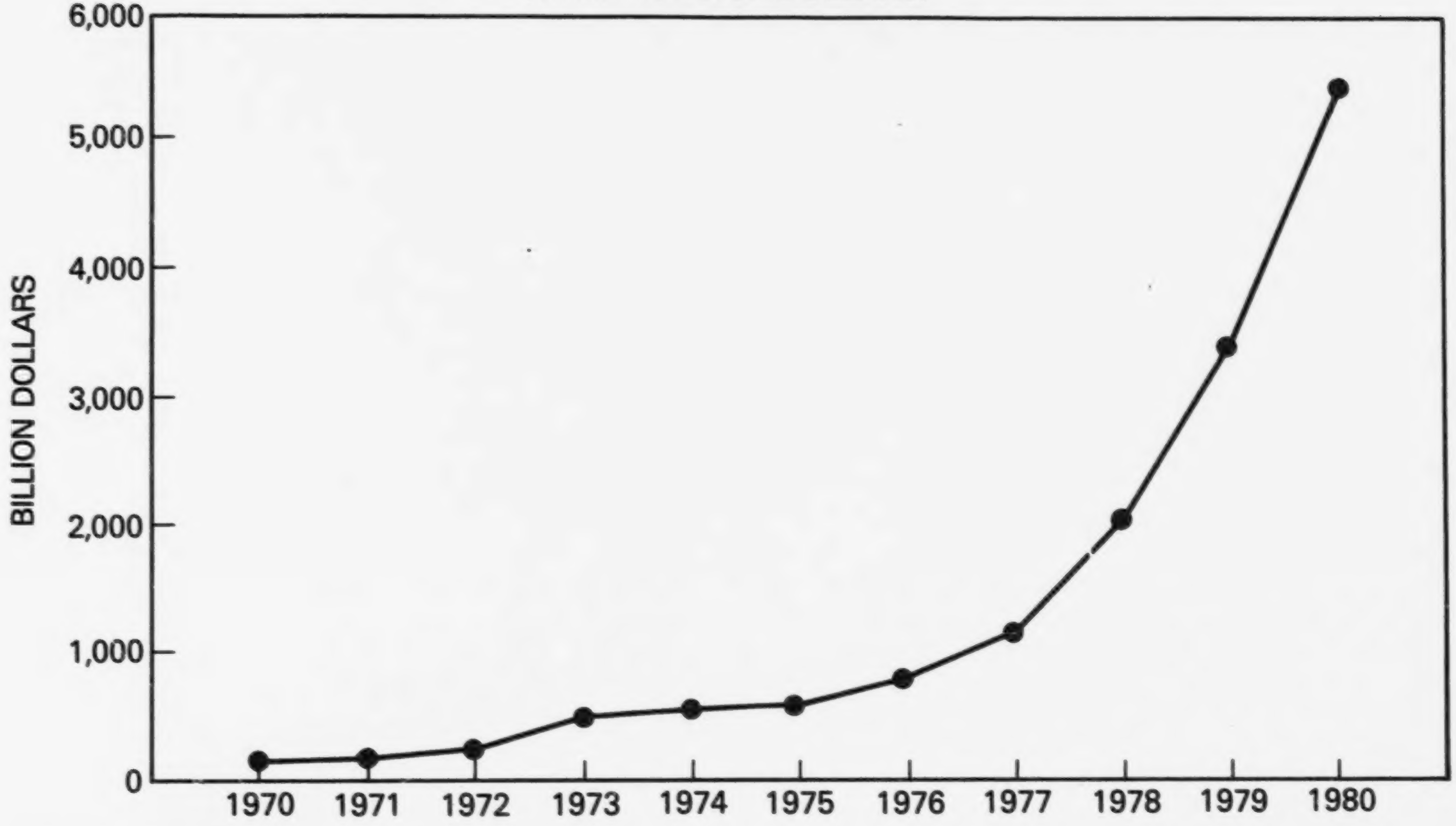
SOURCE: FUTURES INDUSTRY ASSOCIATION, CFTC.

BEST DOCUMENT AVAILABLE

TOTAL VALUE OF FUTURES CONTRACTS TRADED

1970 TO 1980[1]

(IN BILLIONS OF DOLLARS)



SOURCE: FUTURES INDUSTRY ASSOCIATION, CFTC.

[1] 1981 DATA NOT AVAILABLE.

BEST DOCUMENT AVAILABLE

COMMODITIES FOR WHICH MARKETS ARE DESIGNATED

TO TRADE AS OF JANUARY 1, 1982

Commodity/exchange (note a)	Date of designation (note b)	Trading began (note c)
Currencies		
Belgian franc/NYME (note d)	7/18/75	9/12/74
British pound:		
CME	7/18/75	5/16/72
NYFE	5/28/80	8/7/80
NYME (note d)	7/18/75	9/12/74
Canadian dollar:		
CME	7/18/75	5/16/72
NYFE	5/28/80	8/7/80
NYME (note d)	7/18/75	9/12/74
Deutsche mark:		
CME	7/18/75	5/16/72
NYFE	5/28/80	8/7/80
NYME (note d)	7/18/75	9/12/74
Dutch guilder:		
CME	7/18/75	5/16/73
NYME (note d)	7/18/75	9/12/74
French franc/CME	7/18/75	9/23/74
Italian lira:		
CME	9/30/81	-
NYME (note d)	7/18/75	-
Japanese yen:		
CME	7/18/75	5/16/72
NYFE	5/28/80	8/7/80
NYME (note d)	7/18/75	9/12/74
Mexican peso:		
CME	7/18/75	5/16/72
NYME (note d)	7/18/75	9/12/74
Swiss franc:		
CME	7/18/75	5/16/72
NYFE	5/28/80	8/7/80
NYME (note d)	7/18/75	9/12/74

Commodity/exchange (note a)	Date of designation (note b)	Trading began (note c)
Financial instruments		
Certificates of deposit		
Domestic CD/90-day:		
CBT	7/21/81	7/22/81
NYFE	6/30/81	7/9/81
CME	7/28/81	7/29/81
Commercial paper:		
90-day/CBT	7/12/77	9/26/77
30-day/CBT	9/11/78	5/14/79
GNMA:		
ACE (note e)	8/22/78	9/12/78
CBT	9/11/75	10/20/75
COMEX	10/16/79	11/13/79
CD/CBT	9/11/78	9/12/78
CD/NYFE	9/23/81	-
U.S. T-bills:		
90-day/ACE (note e)	6/19/79	6/26/79
1-year/CME	8/25/78	9/11/78
90-day/CME	11/26/75	1/6/76
90-day/COMEX	6/19/79	10/2/79
90-day/NYFE	7/15/80	8/14/80
U.S. T-bonds:		
20-year/ACE (note e)	10/16/79	11/14/79
15-year/CBT	8/2/77	8/22/77
20-year/NYFE	7/15/80	8/7/80
15-year/MACE	9/9/81	9/18/81
U.S. T-notes:		
4-6 year/CBT	6/19/79	6/25/79
4-year/CME	6/19/79	7/10/79
2-year/COMEX	9/30/80	12/2/80
6-1/2 - 10 year/CBT	9/23/81	-
21-24 month/CBT	9/30/81	-
Eurodollar deposits:		
CME	12/8/81	12/9/81
CBT	12/15/81	-
NYFE	12/15/81	-

Commodity/exchange (note a)	Date of designation (note b)	Trading began (note c)
Foodstuffs		
Butter:		
CME	9/13/36	12/1/19
NYME	9/13/36	1884; 1925
Cocoa/CSCE	7/18/75	10/1/25
Cocoa/CSCE		7/23/79
Coffee/CSCE:	7/18/75	3/7/1882
"B"/CSCE		5/2/55
"C"/CSCE		
Eggs:		
Fresh shell/CME	9/13/36	12/1/19
Orange juice/NYCE	7/24/68	10/26/66
Potatoes:		
Russet burbank/CME	9/13/36	1/12/21
Maine, rnd. white/NYME	12/1/41	12/2/41
Sugar/CSCE:	7/18/75	12/16/14
#10/CSCE		
#11/CSCE		
#12/CSCE		
Grains		
Barley:		
MGE	5/2/23	10/9/18
Corn:		
CBT	5/3/23	1859
KCBT	5/5/23	1/2/1877
MACE	10/24/22	Before 1880
MGE	5/2/23	1/30/22
Grain sorghums:		
CME	1/27/71	3/2/71
KCBT	5/5/23	1916; 1944
Oats:		
CBT	5/3/23	1859
MACE	10/24/22	Before 1880
MGE	5/2/23	1/18/04

Commodity/exchange (note a)	Date of designation (note b)	Trading began (note c)
Rice:		
Milled/NOCE	2/12/81	4/9/81
Rough/NOCE	4/8/81	4/10/81
Rye/MGE	5/2/23	1/3/18
Wheat:		
CBT	5/3/23	1859
KCBT	5/5/23	1/2/1877
MACE	10/24/22	Before 1880
MGE	5/2/23	1/2/1885
Wheat, durum/MGE	5/2/23	10/31/73
Industrial materials		
Cotton #2:		
NYCE	9/13/36	9/10/1870
NOCE	6/30/81	7/7/81
Crude oil/NYCE	7/18/75	9/10/74
Gulf Coast No. 2 heating oil/NYME	8/4/81	8/17/81
Heating oil/NYME (note d)	7/18/75	10/23/74
Industrial fuel oil/NYME (note d)	7/18/75	10/23/74
Liquid propane/NYCE	7/18/75	2/1/71
Lumber/CME	7/18/75	10/1/69
NY harbor unleaded gas/NYME	9/1/81	-
NY harbor leaded gas/NYME	9/1/81	10/5/81
Plywood:		
Western/CBT	7/18/75	12/1/69
CME	6/30/81	7/28/81
Stud lumber:		
CBT	7/18/75	12/1/72
CME	10/4/77	12/1/77

Commodity/exchange (note a)	Date of designation (note b)	Trading began (note c)
Wool/NYCE	10/27/54	1941
Gulf Coast unleaded gas/NYME	10/27/81	-
Gulf Coast leaded gas/NYME	10/27/81	12/14/81
Livestock/products		
Broilers:		
CBT	7/18/75	8/1/68
CME	9/25/79	11/6/79
Feeder cattle/CME	6/18/68	11/30/71
Frozen pork bellies:		
CME	6/18/68	9/18/61
MGE	3/19/71	4/5/71
Frozen boneless beef/CME	3/13/70	4/1/70
Frozen skinned hams/CME	7/19/68	2/3/64
Imported lean beef/NYME	8/11/71	9/15/71
Live cattle:		
CME	6/18/68	11/30/64
MACE	9/11/78	9/28/78
Live hogs:		
CME	6/18/68	2/28/66
MACE	9/14/73	6/3/74
Turkeys/CME	7/18/75	10/1/45
Metals		
Copper:		
CME	7/18/75	7/1/74
COMEX	7/18/75	7/5/53
Gold:		
CBT	7/18/75	12/31/74
CME	7/18/75	12/31/74
COMEX	7/18/75	12/31/74
MACE	7/18/75	12/31/74
NYME (note d)	7/18/75	12/31/74
NYME (note f)	10/18/77	11/14/77

Commodity/exchange (note a)	Date of designation (note b)	Trading began (note c)
Palladium/NYME	7/18/75	1/22/68
Platinum:		
CME	7/19/77	Not traded
NYME	7/18/75	12/3/56
Silver:		
CBT	7/18/75	11/3/69
COMEX	7/18/75	7/5/33
MACE	7/18/75	10/68
U.S. silver coins:		
CME	7/18/75	10/1/73
MACE	7/18/75	3/27/72
NYME (note f)	7/18/75	4/1/71
Zinc/COMEX	10/4/77	2/8/78
Oilseeds/products		
Flaxseed/MGE	5/2/23	7/2/20
Soybeans:		
CBT	12/8/40	10/5/36
KCBT	9/10/56	9/18/56
MACE	12/8/40	10/5/36
MGE	9/11/50	9/20/50
Soybean meal/CBT	8/22/51	8/19/51
Soybean oil/CBT	6/30/50	7/17/50
Sunflower seeds/MGE	3/11/80	5/6/80
Soybeans/NOCE	10/27/81	10/29/81
Sunflower seeds/CBT	11/24/81	-

Source: CFTC.

a/Includes only the 11 exchanges designated as contract markets by CFTC and which have active trading, plus one inactive exchange. The New York Futures Exchange was designated July 15, 1980. The New Orleans Commodity Exchange was designated April 9, 1981. The initials used in the table are:

Amex Commodity Exchange	ACE
Chicago Board of Trade	CBT
Chicago Mercantile Exchange	CME
Coffee, Sugar & Cocoa Exchange	CSCE
Commodity Exchange, Inc.	COMEX
Kansas City Board of Trade	KCBT
MidAmerica Commodity Exchange	MACE
Minneapolis Grain Exchange	MGE
New Orleans Commodity Exchange	NOCE
New York Cotton Exchange	NYCE
New York Futures Exchange	NYFE
New York Mercantile Exchange	NYME

b/The term "effective date of designation" is the date upon which the exchange was authorized to begin trading in the contract, not the date of issuance of the designation order.

If an exchange was previously designated by the Secretary of Agriculture as a contract market in a commodity and that designation was in effect on July 18, 1975, CFTC did not specifically designate it as such on July 18, 1975. Those designations continued in full force and effect by virtue of section 411 of the Commodity Futures Trading Commission Act of 1974. Prior to July 18, 1975, the commodities for which designation was granted by the Secretary of Agriculture were among the list of commodities explicitly set forth in section 2(a)(1) of the Commodity Exchange Act, as amended. This listing was limited to the agricultural and animal product commodities.

On July 18, 1975, CFTC gave contract market designation to many of the exchanges which traded in previously unregulated commodities. CFTC had given provisional contract market designations to these exchanges on April 18, 1975, and had extended such designations on May 5. The effect of the July 18, 1975, designations was to bring under Federal regulation all commodities for which a futures market was actively traded. Previously unregulated commodities, such as COMEX's mercury and rubber contracts, for which no contract market designations were granted on that date were not permitted to continue futures trading after July 18.

c/The "trading began" column indicates, according to data supplied by the exchanges, when trading began in a commodity. It is the date of the first recorded futures trading in the commodity, though the contract terms may have changed since then. Dates of some contract term changes, especially those that have originated since the establishment of CFTC, are shown if the change affects the contract size or the deliverable supply.

In the case of copper, silver, and zinc traded on COMEX, trading was suspended for periods of time and then later resumed.

It should be noted that MACE was previously named the Chicago Open Board of Trade until its name change, which was effective November 22, 1972.

KCBT was an unincorporated association until it incorporated in 1973. Effective July 1, 1973, the Commodity Exchange Authority designated KCBT as a contract market in those commodities for which the association previously had been designated.

d/In settling an administrative proceeding CFTC brought against the New York Mercantile Exchange regarding alleged trading abuses, the exchange agreed to suspend trading in these contracts and to seek CFTC approval before resuming trading these contracts.

e/The American Commodity Exchange is now defunct.

f/CFTC revoked the New York Mercantile Exchange's designation as a contract market for these two contracts as part of the above-mentioned administrative proceeding settlement.

CFTC APPROPRIATION AND EMPLOYMENT HISTORY

FISCAL YEARS 1976-81

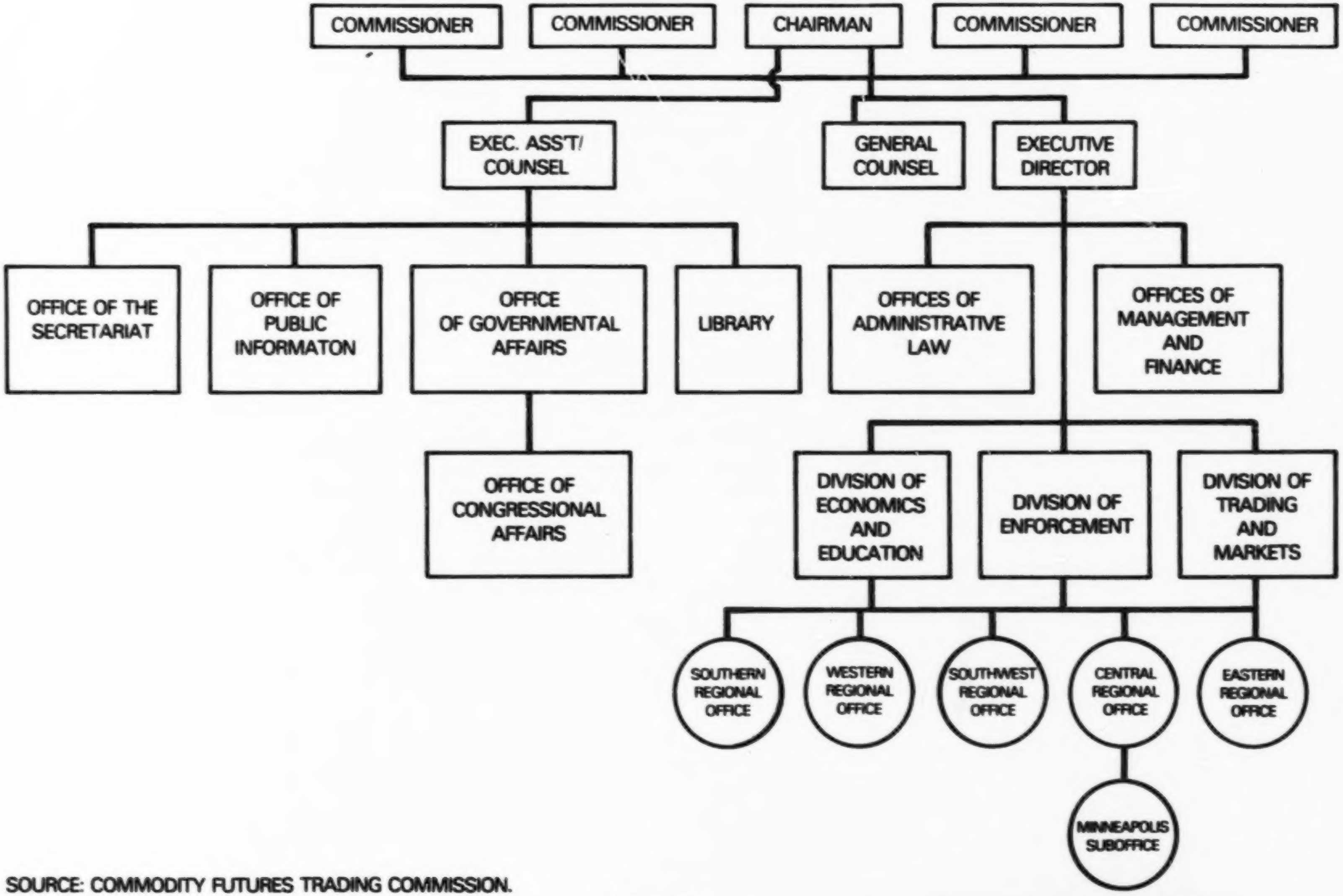
	1976	1977	1978	1979	1980	1981
Appropriation (000 omitted)	$11,483	$13,085	$13,950	$15,836	$16,617	$18,781
Authorized positions	497	470	530	530	550	550
OMB employment ceiling (end of year)	450	450	490	490	500	470
Actual employment (end of year)	374	444	453	452	474	469

Source: CFTC.

APPENDIX V

APPENDIX V

COMMODITY FUTURES TRADING COMMISSION ORGANIZATION CHART


COMMISSIONER
COMMISSIONER
CHAIRMAN
COMMISSIONER
COMMISSIONER
EXEC. ASS'T/ COUNSEL
GENERAL COUNSEL
EXECUTIVE DIRECTOR
OFFICE OF THE SECRETARIAT
OFFICE OF PUBLIC INFORMATON
OFFICE OF GOVERNMENTAL AFFAIRS
LIBRARY
OFFICES OF ADMINISTRATIVE LAW
OFFICES OF MANAGEMENT AND FINANCE
OFFICE OF CONGRESSIONAL AFFAIRS
DIVISION OF ECONOMICS AND EDUCATION
DIVISION OF ENFORCEMENT
DIVISION OF TRADING AND MARKETS
SOUTHERN REGIONAL OFFICE
WESTERN REGIONAL OFFICE
SOUTHWEST REGIONAL OFFICE
CENTRAL REGIONAL OFFICE
EASTERN REGIONAL OFFICE
MINNEAPOLIS SUBOFFICE

SOURCE: COMMODITY FUTURES TRADING COMMISSION.

BEST DOCUMENT AVAILABLE

ORGANIZATION AND RESPONSIBILITIES OF CFTC's OPERATING DIVISIONS

DIVISION OF ENFORCEMENT

The Enforcement Division investigates and prosecutes alleged violations of the Commodity Exchange Act or CFTC regulations involving either the trading of commodity futures contracts on domestic exchanges or the off exchange trading of commodity instruments.

The most common exchange-related violations are attempted or actual manipulations; practices that serve to cheat or defraud customers; and trade practice abuses such as fictitious sales, wash sales, and prearranged trading. Most offexchange violations involve the offer and sale of commodities through arrangements which are actually illegal options or futures contracts. Currently, a ban is in effect on the sale of most commodity options in the United States and futures contracts may be traded legally only through designated exchanges.

As of September 30, 1981, the Division of Enforcement had 94 full-time employees, distributed geographically as follows: Washington headquarters--47; New York--20; Chicago--18; San Francisco--9.

DIVISION OF ECONOMICS AND EDUCATION

This division is responsible for monitoring all active futures contract markets each day to detect and counter any developing threats of corners, manipulation, or other market disturbance. The division is also responsible for (1) reviewing the economic terms and conditions of futures contracts that are currently traded as well as those proposed for trading, (2) performing a variety of economic analysis and research tasks, and (3) preparing and disseminating educational materials and statistical information to help the public better understand futures trading.

As of September 30, 1981, the division consisted of 103 full-time employees, distributed geographically as follows: Washington headquarters--37; New York--28; Chicago--35; Kansas City--2; Minneapolis--1.

DIVISION OF TRADING AND MARKETS

The Trading and Markets Division is responsible for monitoring and evaluating exchange surveillance and self-regulatory activities, for screening applicants for registration as industry professionals, and for conducting audits and reviews of the financial condition and practices of registrants. The division also reviews requests to implement new or revised rules and drafts regulations relating to contract markets and to the registration, surveillance, and auditing of regulated entities.

In fiscal year 1980 a front office audit unit was established in the division to review and evaluate the sales and marketing practices of and the handling of accounts by registered firms and individuals. The main purpose of this front office review is to help assure that sales materials and marketing practices provide fair disclosure of the costs and risks of futures trading and that they are in compliance with relevant CFTC regulations. The front office audit unit also periodically reviews the trading of accounts by brokerage firms to determine if abusive practices, such as churning or allocation of trades, have occurred.

As of the end of fiscal year 1981, the division's permanent, full-time staff numbered 100, broken down by location as follows: Washington headquarters--42; New York--21; Chicago--30; Kansas City--6; Minneapolis--1.

OFFICE OF THE EXECUTIVE DIRECTOR

The Office of the Executive Director is generally responsible for the efficient management and use of CFTC resources. The office plays a leading role in policy, program and staff coordination, general administration and support, and liaison with GAO and with the Office of Management and Budget. In addition, it oversees two of the three agency units (the complaints section and the hearings section) that together operate CFTC's reparations program for resolving customer claims against registered firms and individuals.

As of the end of fiscal year 1981, the staffing of the office and those units which report to it for administrative purposes numbered 96, with the majority (72 percent) located at Washington headquarters.

OFFICE OF THE GENERAL COUNSEL

The Office of the General Counsel represents CFTC before the U.S. Circuit Court of Appeals and (with the Solicitor General) before the U.S. Supreme Court in cases involving review of remedial sanctions ordered by CFTC as a result of its own enforcement proceedings and appeals from district court decisions in CFTC injunctive and subpoena actions. The office also defends the Commission and its staff in suits arising from their official actions and intervenes (as friend of the court) in private litigation in State and Federal courts when issues affecting CFTC regulatory and enforcement activities are involved.

The office also plays an important role in drafting rules for Commission consideration; prepares CFTC guidelines, statements of policy, and interpretations; and reviews proposals prepared by other CFTC divisions and offices for legal sufficiency and for consistency with CFTC policy. The office's quasi-autonomous opinions section manages the Commission's appellate docket of adjudicatory matters and prepares, with advice and concurrence of the General Counsel, background memorandums and opinions and orders related to adjudicatory cases that come before the Commission on appeal. The opinions section is one of CFTC's three units (with the complaints section and hearings section) that collectively operate CFTC's reparations program.

As of September 30, 1981, the permanent, full-time staff of the Office of the General Counsel numbered 36, all of whom were located at Washington headquarters.

MAJOR ORGANIZATIONS AND AGENCIES CONTACTED IN THE COURSE OF OUR REVIEW

Commodity and securities exchanges

New York: Commodity Exchange, Inc.
  New York Mercantile Exchange
  New York Futures Exchange
  Coffee, Sugar and Cocoa Exchange
  New York Cotton Exchange
  New York Stock Exchange
Chicago: Chicago Board of Trade
  Chicago Mercantile Exchange
  MidAmerica Commodity Exchange

Trade groups and associations

Futures Industry Association
National Futures Association
National Association of Securities Dealers
American Arbitration Association
American Institute of Certified
  Public Accountants, Subcommittee
  on Commodity Futures Trading

Federal agencies

Securities and Exchange Commission
Department of the Treasury
Federal Reserve Board
Federal Trade Commission
U.S. Secret Service
Federal Bureau of Investigation
Administrative Office of the United States Courts
International Communications Agency
General Services Administration
Department of Agriculture

Congressional agencies

Congressional Research Service
Congressional Budget Office
Office of Technology Assessment

Futures commission merchants

Shearson Loeb Rhoades, Inc.
Merrill Lynch Commodities, Inc.
Paine Webber, Jackson, & Curtis, Inc.
Heinhold Commodities, Inc.
A.G. Becker, Inc.

Former CFTC Commissioners and officials

Vernon Pherson - former Chief Economist
Hugh Cadden - former Director, Division of Trading and Markets
John Troelstrup
James Goodwin - former Director, New York surveillance branch

Private attorneys

Ralph Foster
Steven M. Clem
Lloyd Kadish (former CFTC employee)
Bernard Doyle
James Fox
Martin Kaplan
Daniel Greenberg
Gerry Markham (former CFTC employee)
William Schief (former CFTC employee)
Jeff Rosen
Fred Spindell (former CFTC employee)
Robert Boraks (former CFTC employee)

CONTRACT APPROVALS

EXAMINED DURING OUR REVIEW

Exchange	Commodity	Designation date
Chicago Board of Trade (CBT)	4-6 year Treasury notes	6/19/79
New York Futures Exchange (NYFE)	90-day Treasury bills	7/15/80
Commodity Exchange, Inc. (COMEX)	2-year Treasury notes	9/30/80
New Orleans Commodity Exchange (NOCE)	Rough rice	4/ 8/81
Chicago Mercantile Exchange (CME)	Plywood	6/30/81
NYFE	Domestic certificates of deposit	6/30/81
CBT	Domestic certificates of deposit	7/21/81
CME	Domestic certificates of deposit	7/28/81
New York Mercantile Exchange (NYME)	Gulf Coast heating oil	8/ 4/81
CBT	Sunflower seeds	11/24/81

OTHER GAO REPORTS CONCERNING

COMMODITY FUTURES REGULATION

1. Letter report on CFTC's Registration Program to Representative Benjamin S. Rosenthal, Dec. 7, 1979 (CED-80-3).

2. "Regulation of the Commodity Futures Markets--What Needs To Be Done?" (CED-78-110, May 17, 1978).

3. "Improvements Needed in Regulation of Commodity Futures Trading," to the Department of Agriculture, Commodity Futures Trading Commission (RED-75-370, June 24, 1975).

4. "Interim Report on the Commodity Exchange Authority and on Commodity Futures Trading," to the Department of Agriculture (B-146770, May 3, 1974).

5. "Need To Strengthen Regulatory Practices and Study Certain Trading Activities Relating to Commodity Futures Markets," to the Commodity Exchange Authority, Department of Agriculture (B-146770, July 16, 1965).

CENTRAL COMPUTER SYSTEM HISTORY

In January 1970, after evaluating seven proposals, the Commodity Exchange Authority selected the National Cash Register Company (NCR) to install a Century 200 computer system in Chicago and Mohawk Data Sciences to install an off-line telecommunications system in Chicago and New York City. The Commodity Exchange Authority began leasing the NCR-200 computer in January 1971, and in 1977 CFTC requested the General Services Administration's (GSA's) authorization to renew the lease for an additional 3 years. The authorization, in the form of an interim delegation of procurement authority issued on March 14, 1977, allowed the lease to continue for 3 years. Given the understanding that the existing system would meet CFTC's requirements for a period of 3 years, the interim delegation was to be valid only if CFTC initiated a competitive procurement action to replace it.

In August/September 1979, CFTC entered into an interagency agreement for $450,000 with GSA to provide data processing consulting in support of a procurement process to replace the NCR-200 system. A project plan was prepared by GSA for an "ADP Requirements Study of the Operations Support Systems" at CFTC. The plan called for completion of a CFTC ADP requirement study report by June 20, 1980; however, the report was never completed. Instead, the interagency agreement was rewritten in January 1981 to emphasize the development of an ADP functional requirement document for specific program areas.

In May 1980 GSA agreed to CFTC's request for a 3-year extension of the 1977 interim delegation of procurement authority to allow CFTC to continue the NCR-200 lease while completing a comprehensive long-range information system plan and conducting a fully competitive procurement to replace the current system. However, on July 15, 1980, GSA charged that agreement to a new delegation of procurement authority, which authorized CFTC to acquire another NCR-200 computer system. Like the earlier delegation of procurement authority, the new one allowed CFTC to complete a requirements analysis for its long-range system support plan and to conduct a fully competitive procurement to replace the NCR-200 system.

In an August 27, 1980, letter to GSA, CFTC reported that it had investigated the availability of the NCR-200 computer system from sources other than the original equipment manufacturer and found none to be available. CFTC also reported that another model NCR computer would meet its requirements--the NCR-8555. Because the expected cost of the alternative computer was to be equal to or less than the NCR-200 and only one source could be found, CFTC requested that GSA change the July 15, 1980, delegation of procurement authority to include the NCR-8555 and remove the requirement to do a formal solicitation.

On September 24, 1980, GSA amended its delegation of procurement authority to reflect the change requested by CFTC. On January 27, 1981, GSA agreed to CFTC's December 15, 1980, request that the delegation of procurement authority be further amended to allow use of a higher performance disk subsystem (658), which CFTC said would allow a 90-percent reliability on the NCR-8555 M system.

THE NUMBER OF COMPLAINTS CFTC USED TO DETERMINE THE ESTIMATED AVERAGE NUMBER OF DAYS IT TOOK TO MOVE COMPLAINTS THROUGH THE ENTIRE REPARATIONS PROCESS (note a)

	Fiscal year					
	1976	1977	1978	1979	1980	1981
Number of complaints CFTC used to determine average number of days from initial filing to a disposition by the complaints section	25	417	695	691	1,228	558
Number of complaints CFTC used to determine average number of days from forwarding the complaint from the complaints section to assignment to a presiding officer	25	371	197	215	226	25
Number of complaints CFTC used to determine average number of days from assignment to a presiding officer to a disposition of the complaint in the hearings section	25	292	178	92	58	3
Number of complaints CFTC used to determine average number of days from filing of application for review to CFTC decision to grant or deny review	4	48	16	(b)	(b)	(b)
If an appeal is granted, the number of complaints CFTC used to determine average number of days between granting of the review until issuance of a CFTC opinion and/or order	2	15	8	(b)	(b)	(b)

a/CFTC included all complaints it could locate (1) which had completed the reparations process and (2) for which the staff had originally recorded the necessary dates to determine the estimated average time required to process through the entire reparations process. CFTC staff first manually sorted through a series of docket cards, recorded the dates, and calculated the number of days. The staff then calculated these estimated averages by dividing the total number of days by the number of complaints in that particular group of complaints.

b/The opinions section has not yet disposed of enough cases in these categories to develop accurate statistics.

PROPOSED AMENDMENTS TO
THE COMMODITY EXCHANGE ACT

To amend the Commodity Exchange Act to broaden the regulatory powers of the Commodity Futures Trading Commission and to authorize the delegation of various Commission responsibilities to registered futures associations.

Be it enacted by the Senate and the House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

(a) Short Title. This Act may be cited as the "Commodity Exchange Act Amendments of 1982."

Sec. 101: In order to authorize the Commodity Futures Trading Commission to delegate its registration functions set out in section 8a (1)-(4) of the Commodity Exchange Act, as amended, and to allow appeals to the Commission from decisions of registered futures associations, section 8a of the Act is further amended by adding a new subsection (10) to read as follows:

> "(10) to delegate to a registered futures association the registration functions listed in paragraphs (1) through (4) in accordance with rules approved by the Commission and subject to the procedural hearing requirements contained therein: provided, however, that any person subject to an adverse decision by a registered futures association may appeal such decision to the Commission who shall afford such person an opportunity for a hearing on the record."

Sec. 102: In order to authorize the Commodity Futures Trading Commission or its delegee to establish examination standards for commodity trading advisors and commodity pool operators, section 4p of the Commodity Exchange Act, as amended, is further amended by inserting the phrase "commodity trading advisors, commodity pool operators," before the phrase "futures commission merchants, floor brokers, and those persons associated with futures commission merchants or floor brokers" where it appears in the first, second, and third sentences thereof and by inserting the phrase "commodity trading advisors and commodity pool operators" at the end of the fourth sentence thereof.

Sec. 103: In order to clarify section 17 of the Act, to expressly authorize a registered futures association to collect the fingerprints of its members and to submit those fingerprints to the FBI, section 17(b)(4)(E) of the Act, as amended, is further amended by adding at the end thereof the following:

> "* * *, which may require the applicant to be fingerprinted and to submit, or cause to be submitted, such fingerprints to the Attorney General for identification and appropriate processing."

Sec. 104: To increase the dollar limitation on claims for which customers can arbitrate, sections 5a(11)(ii) and 17(b)(10)(ii) of the Commodity Exchange Act, as amended, are amended by deleting '$15,000' therefrom and inserting '$25,000' thereto. Sections 5a(11)(ii) and 17(b)(10)(ii) of the Commodity Exchange Act, as amended, are further amended by adding to the end thereof the following:

> ": Provided further, however, that the Commission may periodically adjust the limitation in subparagraph (ii) above to not exceed $50,000 to reflect changes in the Consumer Price Index, in the average amount of claims submitted to the Commission pursuant to section 14 of this Act, and other pertinent factors."

"Sec. 105: To authorize the Commission to disclose certain information to contract markets for market surveillance purposes, section 8a(6) of the Commodity Exchange Act, as amended, is further amended to read as follows:

> "(6) to communicate or routinely supply to the proper committee or officer of any contract market, notwithstanding the provisions of section 8 of this Act, the full facts concerning any transaction, market positions, or market operation, including the names of parties thereto, which in the judgment of the Commission disrupts or tends to disrupt any market or is otherwise harmful or against the best interests of producers and consumers or which in the judgment of the Commission would facilitate surveillance of market activities by any contract market: Provided, however, any information furnished by the Commission under this subsection, either on an occasional or routine basis, shall not be disclosed by such contract market except in a self-regulatory action or proceeding."

"Sec. 106: Conforming Amendments

(a) Section 4f of the Commodity Exchange Act, as amended, is further amended by adding a new paragraph (3) to read as follows:

> "(3) The Commission may authorize a registered futures association to perform any portion of the registration functions under this section, in accordance with rules approved by the Commission, and subject to the provisions of this chapter applicable to registrations granted by the Commission."

(b) Section 4n of the Commodity Exchange Act, as amended, is further amended by adding a new subparagraph (7) to read as follows:

> '(7) The Commission may authorize a registered futures association to perform any portion of the registration functions under this section, in accordance with rules approved by the Commission and subject to the provisions of this chapter applicable to registrations granted by the Commission.'"

DIVISION OF TRADING AND MARKETS'

RULE ENFORCEMENT REVIEWS

Exchange	Ordinal sequence of RER at the exchange	Period covered by RER (target period)	Time of actual audit work	Date of report (or date presented to the Commission*)
New York Mercantile Exchange	a/First	7/75-4/76	Spring 1976	7/12/76
Commodity Exchange, Inc.	a/First	7/75-4/76	Spring 1976	7/12/76
New York Cocoa Exchange	a/First	7/75-4/76	Spring 1976	7/12/76
New York Cotton Exchange	a/First	7/75-4/76	Spring 1976	7/12/76
New York Coffee and Sugar Exchange	a/First	7/75-4/76	Spring 1976	7/12/76
Kansas City Board of Trade	a/First	4/75-6/76	6/14/76-6/15/76	11/11/76*
MidAmerica Commodity Exchange	a/First	1/76-10/76	Began in 5/76	12/8/76
Chicago Mercantile Exchange	a/First	1/1/76-12/30/76	Began on 11/16/76	8/8/77
Chicago Board of Trade	a/First	7/1/76 6/30/77	Began on 7/25/77	1/23/78*
New York Cocoa Exchange	a/Second	12/76-11/77	Unavailable	6/20/78*
Amex Commodities Exchange, Inc.	b/First	Predesignation review	Not applicable	May 1978

Exchange	Ordinal sequence of RER at the exchange	Period covered by RER (target period)	Time of actual audit work	Date of report (or date presented to the Commission*)
New York Cotton Exchange	a/Second	1/77-11/77	Unavailable	9/19/78*
New York Mercantile Exchange	a/Second	8/1/76-12/31/77	Unavailable	6/20/78*
New York Coffee and Sugar Exchange	a/Second	2/1/77-2/1/78	2/79 & 4/79	5/8/79*
Amex Commodities Exchange, Inc.	c/Second	Predesignation review	4/79	6/19/79*
Commodity Exchange, Inc.	a/Second	8/1/77-7/31/78	Unavailable	7/24/79*
Minneapolis Grain Exchange	a/First	1/1/78-12/30/78	3/79 & 4/79	7/24/79*
Amex Commodities Exchange, Inc. (note d)	e/Third	4/1/79-10/25/79	10/79 & 12/79	2/6/80
New York Cotton Exchange	e/Third	10/2/78-9/30/79	10/79 & 11/79	2/20/80*
New York Mercantile Exchange	c/Third	7/31/79-1/31/80	4/30/80-5/2/80	5/23/80
New York Futures Exchange	b/First	Predesignation review	Not applicable	5/20/80
MidAmerica Commodity Exchange	a/Second	9/78-8/79	9/79, 11/79, & 1/80	6/10/80

Exchange	Ordinal sequence of RER at the exchange	Period covered by RER (target period)	Time of actual audit work	Date of report (or date presented to the Commission*)
New Orleans Commodity Exchange	b/First	Predesignation review	Not applicable	2/5/81
Coffee, Sugar and Cocoa Exchange, Inc. (note f)	a/Third	6/1/79-6/1/80	6/80 & 7/81	2/17/81
Kansas City Board of Trade	g/Second	6/79-7/79	2/26/81 & 2/27/81	8/7/81
Commodity Exchange, Inc.	a/Third	8/31/79-3/31/80 & 3/31/80-2/28/81	6/80 & 2/81	9/16/81
Chicago Board of Trade	e/Second	7/1/79-7/1/80	8/4/80 & 9/18/80	4/20/82*
Chicago Mercantile Exchange	a/Second	11/1/79-11/1/80	11/24/80-11/26/80 & 1/5/81-1/7/81	5/25/82*

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a/Broad scope (comprehensive) rule enforcement review.

b/A review of a proposed rule enforcement program of a not yet designated board of trade.

c/An RER done for a specific purpose, such as contract market designation or approval of proposed changes in contract terms and/or exchange rules.

d/The Commission on Aug. 22, 1978, designated the Amex Commodities Exchange, Inc., a new exchange and an affiliate of the American Stock Exchange, Inc., as a contract market for the trading of GNMA certificates. By the end of 1980, the exchange ceased trading pursuant to an agreement among the exchange, the American Stock Exchange, Inc., and the New York Futures Exchange. Under this agreement, the New York Futures Exchange, among other things, extended a membership invitation to Amex Commodities Exchange members.

e/Narrow scope (limited) rule enforcement review.

f/On Sep. 28, 1979, the New York Coffee and Sugar Exchange, Inc., and the New York Cocoa Exchange, Inc., merged to form the Coffee, Sugar and Cocoa Exchange, Inc.

g/A very narrowly focused special purpose review.

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COMPARISON OF FINDINGS OF RULE ENFORCEMENT REVIEWS 1976-81

Exchange: Amex Commodities Exchange, Inc.

Subprogram of regulation 1.51	First rule enforcement review	Second rule enforcement review
1.51(a)(1) Market surveillance		
1.51(a)(2) Surveillance of trading practices		
1.51(a)(3) Examination of members' books and records		
1.51(a)(4) Handling and investigation of customer complaints		The division (note a) found the exchange to be in compliance with regulation 1.51(a)(4) (note b)
1.51(a)(5) Other investigation of alleged or apparent violations		The division found the exchange to be in compliance with regulation 1.51(a)(5) (note b)
1.51(a)(6) Other surveillance, record examination, and investigations		The division found the exchange to be in compliance with regulation 1.51(a)(6) (note b)
1.51(a)(7) Procedures for taking disciplinary actions		
1.51(b) Recordkeeping requirements		(notes b and c)
Date of report	June 19, 1979	February 6, 1980
Date audit work began	April 1979	October 1979
Nature (purpose) of review	An RER done for a specific purpose, such as a contract market designation	Narrow scope (limited) RER
Total staff hours devoted to review	188	1,049

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Exchange: Chicago Board of Trade

Subprogram of regulation 1.51	First rule enforcement review	Second rule enforcement review
1.51(a)(1) Market surveillance	(notes b and d)	(notes b and d)
1.51(a)(2) Surveillance of trading practices	(notes b and d)	(notes b and d)
1.51(a)(3) Examination of members' books and records		
1.51(a)(4) Handling and investigation of customer complaints	(notes b and d)	
1.51(a)(5) Other investigation of alleged or apparent violations	(notes b and c)	
1.51(a)(6) Other surveillance, record examination, and investigations	(notes b and c)	
1.51(a)(7) Procedures for taking disciplinary actions	(notes b and d)	
1.51(b) Recordkeeping requirements	(notes b and d)	
Date of report	January 23, 1978	April 12, 1982
Date audit work began	July 25, 1977	August 4, 1980
Nature (purpose) of review	Broad scope (comprehensive) RER	Narrow scope (limited) RER
Total staff hours devoted to review	Unavailable	5,598 staff hours as of the end of second quarter FY 1982

Exchange: Chicago Mercantile Exchange

Subprogram of regulation 1.51	First rule enforcement review	Second rule enforcement review
1.51(a)(1) Market surveillance	(notes b and c)	(notes b and c)
1.51(a)(2) Surveillance of trading practices	(notes b and d)	(notes b and d)
1.51(a)(3) Examination of members' books and records	(notes b and c)	
1.51(a)(4) Handling and investigation of customer complaints	(notes b and c)	(notes b and c)
1.51(a)(5) Other investigation of alleged or apparent violations	(notes b and c)	(notes b and c)
1.51(a)(6) Other surveillance, record examination, and investigations	The division (note a) found the exchange to be conducting other surveillance as required by this regulation (note b)	(notes b and c)
1.51(a)(7) Procedures for taking disciplinary actions	(notes b and c)	(notes b and c)
1.51(b) Recordkeeping requirements	(notes b and d)	(notes b and d)
Date of report	August 8, 1977	May 17, 1982
Date audit work began	November 16, 1976	April 30, 1982
Nature (purpose) of review	Broad scope (comprehensive) RER	Broad scope (comprehensive) RER
Total staff hours devoted to review	Unavailable	4,015 staff hours as of the end of second quarter FY 1982

Exchange: Coffee, Sugar and Cocoa Exchange, Inc.
(previously the New York Coffee and Sugar Exchange, Inc.) (note f)

Subprogram of regulation 1.51	First rule enforcement review	Second rule enforcement review	Third rule enforcement review
1.51(a)(1) Market surveillance	(notes b and c)	(notes b and d)	(notes b and e)
1.51(a)(2) Surveillance of trading practices	(notes b and d)	(notes b and d)	(notes b and d)
1.51(a)(3) Examination of members' books and records	(notes b and d)		
1.51(a)(4) Handling and investigation of customer complaints	(notes b and d)	(notes b and c)	(notes b anc c)
1.51(a)(5) Other investigation of alleged or apparent violations	(notes b and c)	No conclusion re: 1.51(a)(5) (note b)	
1.51(a)(6) Other surveillance, record examination, and investigations	(notes b and c)	No conclusion re: 1.51(a)(6) (note b)	
1.51(a)(7) Procedures for taking disciplinary actions	(notes b and d)	(notes b and e)	(notes b and c)
1.51(b) Recordkeeping requirements	(notes b and c)	(notes b and c)	
Date of report	July 12, 1976	May 8, 1979	February 17, 1981
Date audit work began	Spring 1976	February 1978	June 1980
Nature (purpose) of review	Broad scope (comprehensive) RER	Broad scope (comprehensive) RER	Broad scope (comprehensive) RER
Total staff hours devoted to review	Unavailable	Unavailable	1,371.25

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Exchange: Commodity Exchange, Inc.

Subprogram of regulation 1.51	First rule enforcement review	Second rule enforcement review	Third rule enforcement review
1.51(a)(1) Market surveillance	(notes b and d)	(notes b and c)	The division (note found that the exchange had implemented the division's 1979 recommendation (note b)
1.51(a)(2) Surveillance of trading practices	(notes b and d)	(notes b and d)	(notes b and d)
1.51(a)(3) Examination of members' books and records	(notes b and d)		
1.51(a)(4) Handling and investigation of customer complaints	(notes b and d)	(notes b and d)	(note b)
1.51(a)(5) Other investigation of alleged or apparent violations	(notes b and d)	(notes b and c)	(notes b and c)
1.51(a)(6) Other surveillance, record examination, and investigations	(notes b and d)	(notes b and d)	(notes b and d)
1.51(a)(7) Procedures for taking disciplinary actions	(notes b and d)	(notes b and d)	(note b)
1.51(b) Recordkeeping requirements	(notes b and d)	(notes b and c)	(note b)
Date of report	July 12, 1976	July 24, 1979	September 16, 1981
Date audit work began	Spring 1976	Unavailable	June 1980
Nature (purpose) of review	Broad scope (comprehensive) RER	Broad scope (comprehensive) RER	Broad scope (comprehensive) RER
Total staff hours devoted to review	Unavailable	Unavailable	4,008.25

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Exchange: Kansas City Board of Trade

Subprogram of regulation 1.51	First rule enforcement review	Second rule enforcement review
1.51(a)(1) Market surveillance	(notes b and c)	Purpose of review: The division (note a) review was conducted to determine the exchange's procedures for establishing settlement prices, its compliance with those procedures, and its ability to detect activities on the close of trading, which may violate exchange rules, e.g., price manipulation. The investigation was precipitated by the Division of Enforcement's general investigation into alleged manipulation of prices of the 1980 wheat contract traded on the exchange in June and July 1979. Conclusions reached: The division believed that the exchange's reactive approach to detecting and investigating prices which are away from the market and may indicate manipulative intent did not satisfy the standards of CFTC Regulation 1.51. The division also had questions concerning the method the exchange used in establishing its settlement prices. According to comments received from the exchange, it did make some changes in settlement price procedures, although denying that there was any substantial problem in existence.
1.51(a)(2) Surveillance of trading practices	(notes b and c)	
1.51(a)(3) Examination of members' books and records	(notes b and d)	
1.51(a)(4) Handling and investigation of customer complaints	The exchange received no customer complaints (note b)	
1.51(a)(5) Other investigation of alleged or apparent violations	No conclusion statement made in the report (note b)	
1.51(a)(6) Other surveillance, record examination, and investigations	The review of the exchange's rule enforcement programs did not reveal any unique problems in this area (note b)	
1.51(a)(7) Procedures for taking disciplinary actions	(notes b and c)	
1.51(b) Recordkeeping requirements	(notes b and c)	
Date of report	November 11, 1976	August 7, 1981
Date audit work began	June 1976	February 26, 1981
Nature (purpose) of review	Broad scope (comprehensive) RER	A very narrowly focused, special purpose review
Total staff hours devoted to review	Unavailable	287

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Exchange: Mid-America Commodity Exchange

Subprogram of regulation 1.51	First rule enforcement review (note g)	Second rule enforcement review
1.51(a)(1) Market surveillance	(notes b and d)	(note b)
1.51(a)(2) Surveillance of trading practices	(notes b and d)	(note b)
1.51(a)(3) Examination of members' books and records	(notes b and d)	
1.51(a)(4) Handling and investigation of customer complaints	(notes b and d)	(note b)
1.51(a)(5) Other investigation of alleged or apparent violations	(notes b and d)	(note b)
1.51(a)(6) Other surveillance, record examination, and investigations	(notes b and d)	(note b)
1.51(a)(7) Procedures for taking disciplinary actions	(notes b and d)	(notes b and d)
1.51(b) Recordkeeping requirements	(notes b and d)	(note b)
Date of report	December 8, 1976	June 10, 1980
Date audit work began	May 1976	September 1979
Nature (purpose) of review	Broad scope (comprehensive) RER	Broad scope (comprehensive) RER
Total staff hours devoted to review	Unavailable	4,193.75

Exchange: Minneapolis Grain Exchange

Subprogram of regulation 1.51	First rule enforcement review
1.51(a)(1) Market surveillance	The division (note a) found the exchange to be in compliance with regulation 1.51(a)(1) (note b)
1.51(a)(2) Surveillance of trading practices	(notes b and c)
1.51(a)(3) Examination of members' books and records	
1.51(a)(4) Handling and investigation of customer complaints	The exchange did not receive any customer complaints during the period reviewed (note b)
1.51(a)(5) Other investigation of alleged or apparent violations	The review of the exchange's rule enforcement program did not reveal any problems in the program which would suggest that the exchange would not be prepared to act in this area if necessary (note b)
1.51(a)(6) Other surveillance, record examination, and investigations	The review of the exchange's program did not reveal any problems in the program which would suggest that the exchange would not be prepared to act in this area if necessary (note b)
1.51(a)(7) Procedures for taking disciplinary actions	No allegations of exchange rule violations with respect to futures trading were made during the period reviewed (note b)
1.51(b) Recordkeeping requirements	The division (note a) found the exchange to be in compliance with regulation 1.51(b) (note b)
Date of report	July 24, 1979
Date audit work began	March 1979
Nature (purpose) of review	Broad scope (comprehensive) RER
Total staff hours devoted to review	1,165

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Exchange: New York Cocoa Exchange

Subprogram of regulation 1.51	First rule enforcement review	Second rule enforcement review
1.51(a)(1) Market surveillance	(notes b and d)	(notes b and d)
1.51(a)(2) Surveillance of trading practices	(notes b and c)	(notes b and c)
1.51(a)(3) Examination of members' books and records	(note b and d)	
1.51(a)(4) Handling and investigation of customer complaints	(notes b and d)	(notes b and d)
1.51(a)(5) Other investigation of alleged or apparent violations		(notes b and c)
1.51(a)(6) Other surveillance, record examination, and investigations		(notes b and c)
1.51(a)(7) Procedures for taking disciplinary actions	(notes b and d)	(notes b and d)
1.51(b) Record keeping requirements	(notes b and d)	(notes b and d)
Date of report	July 12, 1976	June 20, 1978
Date audit work began	Spring 1976	Unavailable
Nature (purpose) of review	Broad scope (comprehensive) RER	Broad scope (comprehensive) RER
Total staff hours devoted to review	Unavailable	Unavailable

Exchange: New York Cotton Exchange

Subprogram of regulation 1.51	First rule enforcement reveiw	Second rule enforcement review	Third rule enforcement review
1.51(a)(1) Market surveillance	(notes b and d)	(notes b and d)	
1.51(a)(2) Surveillance of trading practices	(notes b and d)	(notes b and d)	(notes b and e)
1.51(a)(3) Examination of members' books and records	(notes b and c)		
1.51(a)(4) Handling and investigation of customer complaints	(notes b and c)	(notes b and c)	
1.51(a)(5) Other investigation of alleged or apparent violations		(notes b and c)	
1.51(a)(6) Other surveillance, record examination, and investigations		(notes b and c)	
1.51(a)(7) Procedures for taking disciplinary actions	(notes b and d)		
1.51(b) Recordkeeping requirements	(notes b and d)	(notes b and d)	(notes b and c)
Date of report	July 12, 1976	September 19, 1978	February 20, 1980
Date audit work began	Spring 1976	Unavailable	October 1979
Nature (purpose) of review	Broad scope (comprehensive) RER	Broad scope (comprehensive) RER	Narrow scope (limited) RER
Total staff hours devoted to review	Unavailable	Unavailable	1,103

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Exchange: New York Mercantile Exchange

Subprogram of regulation 1.51	First rule enforcement review	Second rule enforcement review	Third rule enforcement review
1.51(a)(1) Market surveillance	(notes b and c)	(notes b and c)	The division (note a) concluded that the exchange had an acceptable market surveillance program (note b)
1.51(a)(2) Surveillance of trading practices	(notes b and c)	(notes b and c)	(notes b and c)
1.51(a)(3) Examination of members' books and records	(notes b and c)		
1.51(a)(4) Handling and investigation of customer complaints	(notes b and c)	The division (note a) found that the few customer complaints received by the exchange were investigated and processed adequately (note b)	(notes b and c)
1.51(a)(5) Other investigation of alleged or apparent violations		(notes b and d)	
1.51(a)(6) Other surveillance, record examination, and investigations		(notes b and d)	
1.51(a)(7) Procedures for taking disciplinary actions	(notes b and d)	(notes b and d)	The division (note a) concluded that the exchange's program in this area was satisfactory (notes b and c)
1.51(b) Recordkeeping requirements	(notes b and d)	(notes b and c)	(notes b and c)
Date of report	July 12, 1976	June 6, 1978	May 23, 1980
Date audit work began	Spring 1976	Unavailable	April 30, 1980
Nature (purpose) of review	Broad scope (comprehensive) RER	Broad scope (comprehensive) RER	A RER done for a specific purpose, such as contract market designation
Total staff hours devoted to review	Unavailable	Unavailable	239

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a/The Division of Trading and Markets.

b/CFTC evaluated (examined) this area.

c/CFTC found the exchanges' program to be adequate, i.e., not seriously deficient.

d/CFTC found deficiencies in the exchanges' program.

e/CFTC found the exchanges' program to be much improved and now in compliance.

f/On Sep. 28, 1979, the New York Coffee and Sugar Exchange, Inc., and the New York Cocoa Exchange, Inc., merged to form the Coffee, Sugar and Cocoa Exchange, Inc.

g/As a result of this rule enforcement review, the Commission brought an enforcement action against the exchange which was concluded by the payment of a $50,000 penalty and the acceptance of an offer of settlement on Aug. 16, 1977.

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COMMODITY FUTURES TRADING COMMISSION
WASHINGTON, D.C. 20581

OFFICE OF
THE CHAIRMAN

March 8, 1982

Honorable Charles A. Bowsher
Comptroller General of the United States
General Accounting Office
441 G St., N. W., Rm. 7000
Wash., D. C. 20548

Dear Mr. Bowsher:

Thank you for the opportunity to review the draft report prepared by your staff which was given to the CFTC on February 16, 1982. We appreciate the opportunity to comment on this draft. Our comments fall into two general categories: technical or factual errors and general comments on areas which we feel GAO should re-evaluate before the report is finalized.

After your report is completed, we will respond to you in detail on each of your findings and recommendations.

Before commenting on the specific parts of the report, we believe that it is important to place it in the context of the GAO analysis completed in 1978. At that time GAO found that "weaknesses in organization and management have hampered operations." Discussions which the GAO staff had with CFTC in preparation for this report indicate that management under Chairmen Seevers, Stone, and Johnson has been excellent, alleviating most of the concerns expressed in the 1978 report. The GAO staff has said that they did not refer to management in the report because they felt that the difficulties cited in 1978 have been resolved. The report should place its 1982 findings in the context of these discussions and make it clear that the recommendations are GAO suggestions for improvement in addition to the significant actions taken since the last GAO report.

A few other general observations are in order.

-- Over 30 actions recommended by GAO have already been adopted by the CFTC or are in progress.

-- The CFTC's reauthorization package, which was prepared prior to receiving GAO's draft report, addresses a substantial number of items discussed in the report, such as improved market surveillance, registration, and arbitration.

-- The report does not address how internal management improvements have enabled the CFTC to better use its limited resources.

Our specific comments on individual chapters are attached.

The Commission hopes that you will find these comments useful. We appreciate the cooperative working relationships which have existed in the conduct of this review, and we look forward to continuing to work with you on your recommendations.

Sincerely,

PHILIP MCBRIDE JOHNSON
Chairman

Enclosures

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Chapter 1

1. Page 3, last full paragraph, second sentence—It would be more accurate to say that the Commission was authorized through fiscal year 1978.

2. Page 3, last paragraph, second sentence—The Chairman of the CFTC is appointed by the President, with the advice and consent of the Senate. See CEAct Section 2a(2)(B).

3. Page 4, second full paragraph—There are six major components: The Divisions of Enforcement, Economics and Education, and Trading and Markets, and the Offices of the Executive Director, General Counsel, and the Chairman. Support offices could be those either of the Chairman's Office or the Executive Director's Office.

Chapter 2

1. Page 7, first paragraph, second sentence--It would be more correct to say that no funding could be appropriated after September 30, 1982, absent reauthorization action by Congress.

2. Page 9, Second paragraph, first sentence—Same comment as in Chapter 1, item 1.

Chapter 3

1. We feel that it is inappropriate to repeatedly ascribe the time lapse between contract submission and designation to weak management of our E&E Division (pages 23-26). In fact, the reasons for the timing of designations include: (a) the tremendous growth in new applications. If staff hours per contract were held constant and allocated total staff time were also constant, a hugh influx would necessarily slower output; (b) the need to answer questions posed internally and by other agencies of a fundamental and precedential nature about some of the new contracts. Once a threshold contract has been approved, others can follow quickly. During the GAO study period there were many threshold contracts filed; (c) during the period of the silver study, a substantial proportion of contract review personnel were assigned to that project and no contract reviews were completed during the first quarter of fiscal year 1981; and (d) an emphasis at the senior management level on self-regulatory and regulatory requirements, now in place, which were felt to be essential preconditions of a rapid increase in designations.

2. This chapter consistently refers to CFTC's "approval" of new contracts. The CFTC "designates" contract markets pursuant to requirements and procedures set forth in Sections 5 and 6 of the CEAct rather than approves them.

3. Page 12 should include that part of the designation review which requires that a contract not be conducive to price manipulation or distortion.

GAO note: Page numbers referring to our draft report have been changed to refer to the final report.

4. Page 15, second full paragraph, item (1)—If a term or condition does not conform to normal commercial practices, it must be shown why it is necessary or desirable. (See Guideline I.)

5. Pages 19 and 20--It should be pointed out that 1.50 reviews have not been made on a routine basis because of a management decision to give higher priority to new contracts and to limit 1.50 calls to cases in which the Commission believes there are significant deficiencies which represent potential market problems. In addition, in fiscal year 1981, the Commission did authorize 1.50 calls on 12 contract markets. Eleven of these calls became unnecessary because two of these designations were subsequently revoked and for the remainder, the exchange agreed to request and obtain Commission approval prior to listing additional trading months. The 1.50 review of cotton which was initiated by the Commission in fiscal year 1981 is continuing.

6. Page 22, second full paragraph, ninth line—CFTC did not propose to suspend trading in dormant contracts. This could only be done by formal Commission action (see Section 6b). The proposal would rather require the exchanges to receive CFTC approval under Section 5a(12) to restore trading in a dormant contract. This was also mentioned on page 32 in this chapter. (See GAO note.)

7. We would also note that the processing of new futures contracts accelerated substantially in the last half of 1981. As a result, twenty contract proposals were cleared in the July-December period, as compared with two such actions in the earlier period of 1981, reflecting basically a shift in emphasis in that period as well as the relative absence of crises, such as the silver situation, which had consumed substantial staff time in the earlier period. While this development was known to GAO as well as to others, it is not even acknowledged in the draft report's discussion of new contract designations.

Chapter 4

1. Page 40, second full paragraph, first line--Change November 1981 to January 1, 1982.

2. Same sentence, third line--Change "daily" to "routinely" as '03 reports were required only when a reportable trader's position changed.

3. Page 41, second and third paragraphs--These are not correct as written. The '01 and '03 reports collect essentially duplicate data. Prior to the 1970s, series '03 reports were adequate for surveillance purposes because of the physical proximity of the largest of the traders in New York and Chicago. This insured that the bulk of the reported information was timely, and futures trading volume was low enough that futures trading data could be expeditiously handled by the Commission's predecessor agency. However, as trading volume increased, the locations of traders decentralized.

GAO note: This material has been deleted from the report.

As the trends in growth and decentralization continued, the '01 reports filed by FCMs gradually replaced the '03 reports as the major reports used for surveillance. The '01 reports were received in a more timely fashion than the '03 reports (hand delivered daily by the FCMs vs. ma[illegible] by individual traders). Moreover, as the series '03 reports [illegible] to be filed by less experienced, less professional traders, they became increasingly less accurate.

4. Page 41, fourth paragraph, first line—"January 1981" should be "January 1982."

5. Page 42, footnote 2—Under CFTC's new reporting regulations, hedgers and speculators will be replaced with a commercial, non-commercial classification. The footnote should be corrected to reflect this change.

6. Page 45, last two sentences of the first full paragraph—We are uncertain as to this reference. Recent ADP hires have been in Washington. The '03 changes are being done in Chicago by ADP programmers who have been with CFTC over 2 years.

7. Page 45, last paragraph--Add a sentence "The ADP Section is currently designing programs to enter cash prices into the system."

8. Page 46, second paragraph, seventh line—Change ". . . data have not been developed . . ." to ". . . data are just now being developed..."

9. Page 46, paragraphs three and four--These two paragraphs are very confusing and misleading. The suggestions relate to timing and should be clarified.

10. Page 54, first full paragraph, first line—Add a "to" between "needs" and "improve."

Chapter 5

The Commission has already taken steps to implement almost all of GAO's recommendations with respect to the Commission's registration function.

Chapters 6 and 7

The Division of Trading and Markets has provided the Commission with extensive comments on Chapters 6 and 7 of the draft report, which are attached hereto. Those comments address serious inaccuracies in the draft report's description of the Commission's auditing and rule enforcement review programs. Accordingly, the Commission requests that any publication of its comments fully include the attachment and that the GAO amend its report to reflect the comments expressed by the Division of Trading and Markets.

Chapter 8

1. Page 165, first paragraph--We disagree that the reparation process is slow because the Chief ALJ (1) does not immediately assign complaints to presiding officers and (2) has not developed any standards which would encourage the presiding officers to maintain high productivity. While both of these areas may lead to improved production, it is unfair to blame them for a slowdown since each judge has an extensive docket of enforcement and reparations cases and the Chief ALJ reviews their caseload and production on a periodic basis.

2. In this same paragraph we would also like you to reconsider the statement that the agency has not designated a qualified staff member to answer the parties' legal and procedural questions. Each ALJ has a clerk to answer questions about cases on the judge's docket and a person in the Chief ALJ's office provides information to parties whose cases are pending assignment with the Chief ALJ. On unassigned reparations cases, the Hearing Clerk provides status information. Additional steps are being taken to insure that these staff members are adequately responsive.

3. The statistics in this chapter do not consider the large number of cases stayed by the Commission or cases stayed by the courts due to bankruptcy and receiverships. The report should reflect these items.

4. The statistics also do not take into account the qualitative factor in reparations, i.e., the complex issues which cases often present which can only be resolved by careful study and analysis. Although these complex issues may take time to decide initially, the decisions save time in the long-run by clarifying legal and marketplace issues.

5. Page 178--There are discrepancies between GAO statistics and CFTC statistics concerning cases pending before the Commission. Apparently, GAO has defined "disposition" of a case as including only orders denying review and full opinions. However, the Commission does issue other types of orders which dispatch cases. CFTC statistics show 91 cases pending at the end of 1981.

6. The GAO Report states at page 189 that "the CFTC has taken little action to ensure that the exchanges have arbitration programs that meet legislative and agency requirements." This statement does not recognize that since the Commission adopted Part 180 of its regulations, it has received, reviewed, and approved complete arbitration rules packages from all eleven exchanges currently designated as contract markets. GAO also concludes that the Commission should conduct rule enforcement reviews of all exchange arbitration programs before proceeding with proposed amendments to Part 180. While the Division of Trading and Markets believes that reviews of each exchange's arbitration performance may be appropriate, such reviews are not essential to proceeding with the proposed amendments to Part 180.

First, rule enforcement reviews are not the primary means by which the Commission maintains its awareness of how exchange arbitration responsibilities are performed. For example, as a basis for proposing amendments to Part 180, the Division contacted several exchanges to determine the actual procedures by which they operate. Staff worked closely with those exchanges in order to become familiar with their systems, documentation, and statistics concerning use of their procedures. Second, the Division intends to scrutinize the comments received from the exchanges and other interested persons and take them into consideration when recommending Commission adoption of the final amendments. Those comments may also be helpful in guiding the development of an arbitration system by the NFA.

Chapter 9

Page 211--ADP Steering Committee--During an October 1981 meeting, the Executive Director informed the GAO staff that once the new ADP staff was in place the Steering Committee would be revived. At the time of GAO's interview with the new ADP Director, he was not aware of the Steering Committee plans as this was early in his tenure. However, discussions had been held regarding the Steering Committee by ADP staff with the Executive Director prior to December 31, 1981. Action was deferred until the new ADP team was on board and had charted a new direction.

AUDIT AND FINANCIAL REVIEW (CHAPTER VI)

THE COMMISSION SHOULD REDUCE THE NUMBER OF AUDITS OF MEMBER FCMS AND RELY INSTEAD UPON THE EXCHANGES TO BE THE PRIMARY MONITORS OF MEMBER FCMS

The Commission does not believe that excessive resources have been devoted to auditing member FCMs. As the draft report points out, the Commission needs to conduct certain audits of member FCMs not only to evaluate the performance of the exchange audit programs but to monitor compliance with the Commission segregation and recordkeeping regulations. Experience has shown that periodic visits to member FCMs significantly improve the levels of compliance with those regulations. Over the past several years the procedures utilized by the Commission staff when auditing member FCMs have been considerably streamlined so that these audits take much less time to conduct. That is the primary reason why the Commission staff has been able to conduct more audits of non-members and CPOs without conducting significantly fewer audits of members. The Commission considers this efficiency not a deficiency. Simply comparing the total number of member audits (150) to the total number of non-member audits (150) is not an accurate measure of the level of audit coverage. First, because of the streamlined procedures utilized in member audits the amount of staff hours spent on non-member audits was significantly greater than that expended on member audits. Second, it's important to recognize that there are more than three times as many members as non-members. In any event, however, the Commission staff will not be able to audit member FCMs as frequently in the future because of the additional resources being devoted to auditing CPOs. In fact, approximately 70% of the FCM audits conducted during the first four months of FY 1982 have been of non-members.

THE COMMISSION SHOULD DEVOTE ADDITIONAL AUDIT RESOURCES TO MONITORING NON-MEMBER FCMS AND CPOS

The Commission recognizes the importance of auditing and monitoring "non-member" FCMs on a frequent basis. In fact, major steps have already been taken to accomplish this. For example, beginning in December 1980, the Commission required non-member FCMs which hold customer funds to contact the Commission's audit staff on every business day to report their segregation calculations, and written segregation reports must be filed weekly. In addition, to the extent possible, the audit staff visits each non-member FCM with over $1 million in customer funds at least once each month to perform a limited scope audit. While the draft GAO report acknowledges that the Commission has increased the number of audits of non-member FCMs it fails to mention these substantive new audit and surveillance techniques.

The Commission does not believe that its audit coverage of non-members has been inadequate. The draft report indicates that 83 non-member FCMs were registered at the end of fiscal year 1981. The draft report also mentions that no audits were conducted of 33 non-members (none of which held customer funds on September 30, 1981). Therefore, based on the fact that 150 audits of non-members were conducted during fiscal year 1981, it would appear that remaining non-members were audited an average of three times during the year.

The Commission disagrees with the contention that it is necessary to audit each non-member FCM at least once every two years even if the FCM does not hold customers' funds. The protection of customers' funds is by far the most important reason for conducting financial audits of FCMs. Therefore, firms with no customer funds will always constitute the lowest audit priority. Furthermore, the draft report fails to adequately explain that while 33 non-members were not audited by the CFTC, those FCMS were audited each year by an independent public accountant, and the FCMs filed quarterly financial reports which were thoroughly reviewed by the Commission's audit staff.

The Commission also recognizes the necessity to conduct more audits of CPOs. This has already begun. For example through the first four months of fiscal year 1982, the Division of Trading and Markets has completed 37 financial audits of CPOs. At this rate 111 financial audits of CPOs would be completed during FY 1982, or a more than 50% increase over FY 1981. In addition, staff hours are being devoted to CPO financial audits at about twice the level of FY 1981.

THE COMMISSION SHOULD PROVIDE ADDITIONAL SPECIFIC GUIDANCE FOR THE CONDUCT OF EXCHANGE AUDIT AND FINANCIAL SURVEILLANCE PROGRAMS

The Division of Trading and Markets' Interpretation No. 4 was intentionally structured to provide guidance to exchanges rather than to dictate that each exchange adopt identical procedures and program elements. While it is important that all exchange programs meet certain basic requirements, each exchange should be encouraged to develop programs to fit its special circumstances. The Commission believes that Interpretation No. 4 provides adequate guidance to the exchanges, and accordingly the Interpretation need not be amended.

THE COMMISSION SHOULD WORK WITH THE AICPA TO ENSURE THE TIMELY PUBLICATION OF AUDIT GUIDELINES FOR USE BY INDEPENDENT PUBLIC ACCOUNTANTS IN PERFORMING AUDITS OF FCMS

The Commission continues to believe that detailed guidelines for conducting audits of FCMs should be developed by the accounting industry, i.e. the AICPA's Auditing Standards Sub-Committee on Commodity Futures. The Commission staff will work with the Sub-Committee in order to develop and issue guidelines as soon as practicable. The staff will, of course, ensure that such guidelines meet the CFTC's needs and satisfy its requirements.

THE COMMISSION SHOULD DEVELOP A PLAN FOR THE TRANSFER OF SPECIFIC AUDITS FUNCTIONS TO THE NFA

The Commission does not believe that it would be an appropriate use of its limited resources at this time to develop a formal plan for delegating audit and financial surveillance responsibilities to the NFA. The staff of the Division of Trading and Markets has had a number of discussions with the organizers of NFA concerning audit and financial surveillance activities and this dialogue will continue. However, until such time as NFA engages an audit staff, efforts to develop a formal plan would be of little benefit and certainly not worth the resource commitment.

THE COMMISSION SHOULD PERFORM MORE FREQUENT REVIEWS OF THE EXCHANGES' AUDIT AND FINANCIAL SURVEILLANCE PROGRAMS AND PERFORM MORE ACTIVE FOLLOW-UP SO THAT EXCHANGES MODIFY THEIR AUDIT AND FINANCIAL SURVEILLANCE PROGRAMS TO COMPLY WITH CFTC'S RECOMMENDATIONS

The Commission agrees that reviews of exchange programs should be performed on a frequent enough basis to ensure continued compliance with the self-regulatory requirements of the Act and CFTC regulations. However, we do not agree with the conclusion that such reviews to date have been insufficient. It is important to note that staff members of the Division of Trading and Markets have very frequent contact with the audit staffs of the exchanges in which problems or concerns about an exchange's program are discussed and rectified. While periodic formal program reviews are necessary and will be continued, the day-to-day oversight function is equally if not more important.

The Commission does not agree with the conclusion that it has not been forceful enough in requiring exchanges to adopt recommendations made as a result of audit and financial surveillance program reviews. The vast majority of recommendations made by the Division of Trading and Markets have been adopted by the exchanges. The staff has not accomplished this by being passive. In addition, with respect to the specific example cited in the draft report it should be noted that the New York Cotton Exchange's overall program was quite good and that we know of no instance in which the New York Cotton Exchange failed to notify the Commission of financial or segregation violations it has discovered.

Chapter 7

Chapter 7 of the GAO Report examines the CFTC's rule enforcement review program and concludes that "while some significant improvements have been made, there remain weaknesses of a serious nature." The GAO asserts that these weaknesses include the largely descriptive nature of rule enforcement reviews, problems relating to the planning, scoping and conduct of reviews, inefficiencies in the use of staff resources and expertise, lack of prompt follow-up on report recommendations, and insufficient Commission direction, control, and support of the rule enforcement review program.

The Division believes that the GAO Report does not give a fully accurate picture of the Division's rule enforcement review program, nor does it take into account all of the improvements which the Division has implemented in the program or the significant intervening events which have caused some delays in completing recent major rule enforcement reviews. Moreover, in reaching its conclusions, GAO places exaggerated and unfounded emphasis on its flawed review of a Division inspection of the New York Mercantile Exchange ("NYME") which can in no way be characterized as representative of the overall program. The following discussion is intended to provide GAO with the Division's comments concerning the descriptive nature of Division reports, the misplaced and inaccurate analysis of the Division's review of the NYME, the proper focus of Division reviews, factors which have caused delays in completing some recent reviews and GAO's conclusion that the Division has not found a way to keep current with exchange rule enforcement programs. Following the discussion of these major points, other specific inaccuracies in the GAO Report are noted.

1. Rule enforcement review reports will, of necessity, always involve a certain degree of descriptive material in presenting the Division's evaluation of each exchange's program. This descriptive material serves two purposes:

   (a) To document the nature and uses of the exchange rule enforcement programs or systems which the Division has evaluated; and

   (b) To provide the Commission and other readers of the report a sufficiently adequate basis for understanding any criticisms or recommendations which the Division may make with respect to the exchange programs evaluated.

   Apart from recognizing the need for a certain amount of descriptive material in any rule enforcement review, the GAO does not adequately acknowledge that the most recent reviews have gone considerably further than previous reviews in providing specific documentation designed to assess the actual operational effectiveness of exchange programs. In this regard, the planning, conduct and actual reports associated with recent reviews have all been directed toward evaluating actual exchange investigations and systems and presenting that documentation in the reports presented to the Commission.

2. The GAO Report cites as a primary example of its perceived inadequacies in the conduct of the Division's program an inspection of the New York Mercantile Exchange. The GAO's characterization of that Report completely misrepresents the nature and limited purpose of the Division's review as well as mischaracterizes the results of the Division's review in comparing it with a concurrent Division of Enforcement investigation of the NYME. As serious as these misrepresentations themselves are, their impact has been further exaggerated by GAO testimony before

Congressman Rosenthal, in which senior GAO officials ignore the GAO Report's general findings and repeat the Report's mischaracterization of the Division's review of the NYME.

The GAO's overall conclusion with respect to the Division's rule enforcement review program is that "while some significant improvements have been made, there remain weaknesses of a serious nature." In testimony before Congressman Rosenthal, however, Henry Eschwege, a Divisional Director of the GAO, completely disregarded his Office's general conclusion and stated that "rule reviews have improved marginally" but that "substantial improvements are still required." In addition to this erroneous statement, Mr. Eschwege also repeated the misrepresentations of the staff report by stating that "a CFTC review of the NYME conducted in 1980 overlooked serious problems brought to light in a separate 1980 CFTC Enforcement investigation".

The GAO Report and Mr. Eschwege's testimony assert that the conclusions of Trading and Markets' review "were almost totally contradicted" by the Enforcement investigation and leave the clear impression that one arm of the Commission staff was completely unaware of a contemporaneous pending investigation being conducted by another arm of the Commission's staff. In fact, nothing could be further from the truth -- a truth documented in staff memoranda to the Commission made available to GAO, but which GAO has chosen to ignore. In particular, the GAO report makes no mention of a May 12, 1980 memorandum from the Division of Trading and Markets to the Commission in which the nature and results of its inspection are discussed. Instead, GAO relies entirely on the initial report of the

Division of Trading and Markets' regional staff; a report which itself was never transmitted to the Commission and, both within the Division of Trading and Markets and as explained to GAO staff, was viewed as having a very narrow purpose and limited depth.

The following specific points summarize information previously made available to the GAO concerning its treatment of the NYME review:

(a) The GAO Report ignores the extremely limited nature and scope of the Division of Trading and Markets' review and the reasons for conducting the review. The Division of Trading and Markets initiated this review specifically in light of its knowledge of the Division of Enforcement's investigation because the Commission at that time was to consider major rule changes designed to eliminate serious and recurring problems in the NYME potato contract. Thus, the Division of Trading and Markets' report focuses substantially on the NYME's surveillance capabilities with respect to potato futures trading. The limited scope of the Division of Trading and Markets' review is clear from the fact that the entire staff work on this review consumed only 240 hours, whereas typical rule enforcement reviews conducted by the Division have consumed as much as 2,000 staff hours. This fact is noted in the Division of Trading and Markets' May 12, 1980 memorandum in which the Division states that "this effort was not structured to be a full scale rule enforcement review or to obviate the need for such review in the course of the Division's ongoing rule enforcement program."

(b) The GAO Report at page 116 states that the Division of Enforcement's investigation into trade practice abuses at the NYME "originated in referrals from CFTC market surveillance personnel." The initial referral originating from market surveillance in this matter was transmitted jointly to the Divisions of Enforcement and Trading and Markets. By memorandum dated February 2, 1978 both Divisions agreed that the Division of Trading and Markets would conduct the initial inquiry into the market surveillance referral. This Division proceeded with its inquiry and, by memorandum dated June 9, 1978 presented the Division of Enforcement with its findings. Those findings were the basis of the Division of Enforcement's preparation of a formal order of investigation and the ultimate complaint filed by the Commission in this matter. The Division revives this history at this time only to demonstrate that it has since early 1978 been actively involved in evaluating the rule enforcement capability of the NYME. The Division's continual awareness of the investigation and findings of the Division of Enforcement are an inescapable fact.

(c) GAO expresses its perplexion that, having previously conducted basic reviews of the NYME, the stated purpose of this Division of Trading and Markets' review was to determine whether the NYME had any rule enforcement program in place. The May 12, 1980 memorandum from the Division of Trading and Markets answers GAO's questions by stating that the purpose of the Division of Trading and Markets' inspection was to provide the Division with current information on the self regulatory performance of the Exchange. The Division's May 12, 1980 memorandum states clearly that its review was initiated specifically in light of the Division of Enforcement's investigation, which by then had confirmed serious violations of the Act by NYME members in two contracts traded on that Exchange and in response to the Division of Enforcement's questions as to whether NYME ought to be designated as a contract market in any contract, including potatoes. The Division of Trading and Markets was clearly aware of the Division of Enforcement's concerns with respect to the NYME program and it was precisely those concerns which led it to review whether NYME had a basic self regulatory program in place.

(d) The GAO Report leaves the impression that the focus of both the Division of Trading and Markets and the Division of Enforcement inquiries was the same time period. In fact, the Division of Enforcement's inquiry was focused on trading abuses in two contracts trading on the NYME during 1977 and 1978. The Division of Trading and Market's review focused on a time period in late 1979 and early 1980 over one year after the abuses which the Division of Enforcement was investigating had occurred. More importantly, the Division of Trading and Markets' staff report on the NYME compliance program clearly shows that the Exchange had made notable improvements in its compliance program during that one year interim period. Specifically, the staff report at page 8 notes that in January 1980, the Compliance Department had hired three new investigators and one auditor. In addition, the Exchange was at that time reorganizing its compliance staff into two independent sections, one for trade surveillance and the other for financial surveillance. While neither the initial staff report or the Division of Trading and Markets' subsequent memorandum to the Commission indicated in any way complete satisfaction with improvements in the NYME program, it is clear that significant changes in that program had been effected between the time that the Division of Enforcement was investigating and the time at which the Division of Trading and Markets conducted its review.

(e) The GAO Report's conclusion of contradictory Division findings is erroneous. In fact, in its May 12, 1980 memorandum to the Commission on this subject, the Division of Trading and Markets recognized the limited nature of its inquiry and the potential that the Division of Enforcement would find serious violations during the time period it reviewed. However, it also recognized that there was a significant public interest in seeing improvements to the NYME potato contract effectuated. The Division thus noted that "whatever conclusions the Division of Enforcement may reach with respect to the adequacy of the NYME compliance program, the Commission's review of these rule proposals under section 5a(12) of the Act is unlikely to provide an appropriate forum for consideration of the recommendations which the Division of Enforcement may make with respect to the

> future of the NYME. Even if the Exchange's compliance program were found to be inadequate, the Division does not believe it would be appropriate for the Commission to defer approval of these amendments, since they effect changes in the contract which represent a distinct improvement in the contract and appear to serve a broader public interest in the proper functioning of the contract. Further, approval of these rules does not jeopardize the Commission's authority in any other context to take enforcement action against the NYME or seek vacation of its designation in this or any other contract." (emphasis added)

3. Following the GAO's 1978 Report, the focus of the Division of Trading and Markets' Rule Enforcement Reviews shifted from broad-based reviews of each exchange's entire rule enforcement program to more narrow inquiries directed at specific aspects of each exchange's self-regulatory programs. This change in focus recognized the difficulty of gaining more than a superficial understanding of an exchange's overall program when attempting to review the entire breadth of such programs. The new focus has allowed the Division to target its rule enforcement resources at specific aspects of exchange programs which the Division has reason be believe may be deficient or which otherwise merit scrutiny. Recent examples include reviews of the Coffee, Sugar and Cocoa Exchange's trade practice program and a review of the Kansas City Board of Trade's procedures for monitoring trading at the close.

   Further, in criticizing the Division's selection in its pending CBT rule enforcement review of only two of the eight regulation 1.51 criteria required of exchange rule enforcement programs, the GAO Report makes no mention that the two elements selected for review are the two most significant elements, that other elements are largely derivative from or dependent upon successful exchange implementation of those two elements, or that the previous CBT review found the most serious deficiencies in its programs required by those two elements.

Finally, while the Division respects the effort and independent viewpoint which the GAO staff has brought to its audit of the Division's performance in this area, the Division strongly believes that the conduct of limited scope reviews is essential to its ability to deliver timely, yet thoroughly documented analyses of exchange's self-regulatory performance. Unfortunate as the delays in completing the current CBT and CME reviews have been, the Division believes it would be inviting similar delays in other reviews if it abandoned its efforts to specifically target its reviews to those exchange programs which are most essential or which have caused the Commission to have specific concerns as to their adequacy.

4. As noted above, GAO correctly observes that a significant period of time has elapsed between rule enforcement reviews of both the CBT and CME and notes that, while pending reviews of those exchanges are near completion, their completion has extended over a considerable length of time. First, it should be noted that the Division has committed itself to completing the CBT review by the end of March and the CME report in mid-April.

Second, notwithstanding the change in focus of the Division's reviews, a review of even limited aspects of a major exchange's program is a significant undertaking. In order to fully understand how those specific aspects of an exchange's program operate and whether they are effective, Division staff conduct extensive interviews of exchange compliance and supervisory personnel, as well as selected members; review and reconstruct exchange investigations of trading activity or financial audits; and conduct independent trade practice investigations to determine whether the scope and thoroughness of exchange programs are adequate.

These rule enforcement review functions are conducted by a limited staff, whose additional routine duties include daily floor surveillance, review of exchange disciplinary and emergency actions, the conduct of routine trade practice investigations, and review of exchange rules relating to trading practices and disciplinary procedures.

The GAO has noted that three recent rule enforcement reviews (one completed - Comex, two pending - CBT and CME) have consumed more time than initially planned by staff. In addition to the traditional rule enforcement scope of each of these reviews and the Division's attempt to thoroughly document its analyses, each of these reviews took on the additional burden of analyzing significant exchange emergency actions taken in the context of major price movements in metals contracts traded on those exchanges. In two of the three reviews, this added task has involved an in-depth review of allegations that Board members involved in decisions to take emergency actions had conflicts of interest. This review required major expenditures of time and resources to identify Board members' relevant positions and to analyze how those positions might have affected any actions taken.

Finally, the Division notes that a number of intervening events have caused substantial diversions of available resources from the conduct of ongoing rule enforcement reviews. During the past two years alone, the necessary involvement of the Division's Rule Enforcement Review Unit in monitoring the silver situation; subsequently investigating various conflict of interest allegations related to the silver situation; reviewing the rule enforcement, disciplinary, and trade practice aspects of initial designation applications by both the New York Futures Exchange and the New Orleans Commodities Exchange; and reviewing the rule enforcement and disciplinary aspects of the NFA registration application has diverted approximately 2½ staff years from the conduct of formal rule enforcement reviews of ongoing exchange operations.

In none of these instances can the Division conclude that the time diverted from perhaps more traditional rule enforcement activities was unnecessary or ill-spent. Indeed, the Division believes that its involvement in monitoring developments in the silver market and its aftermath were absolutely essential. Further, the Division believes that the resources which it expends in assuring that an exchange commences operations only if it has a fully satisfactory rule enforcement program can only result in better protection of the public and consequent savings in staff resources in subsequent years. Similarly, the Division has attached and will continue to attach priority importance to assuring that proposed NFA programs are fully consistent with the Act and designed to make that organization an effective supplement to existing self-regulatory efforts.

5. The GAO Report concludes that staff and the Commission "have not yet found a way to keep current of exchange rule enforcement." Implicit in this statement is that rule enforcement reviews are the only means by which it is possible to have an up-to-date understanding of an exchange's program. In fact, however, as has been stated to GAO on more than one occasion, a rule enforcement review is only one of a number of methods by which to keep track of such programs. Other means used include trade

practice investigations, which have increased in recent years from 45 in FY 80 to 75 in FY 81 and which have resulted in numerous referrals to either the exchanges or the Division of Enforcement; routine daily floor surveillance; ongoing reviews of exchange disciplinary notices and emergency actions; and the review of exchange rules relating to trading practices and disciplinary procedures.

Indeed, to take but one example, the Division recently expressed reservations concerning the adequacy of the New York Mercantile Exchange's rule enforcement review program when evaluating its application to trade a Gulf Coast No. 2 Heating Oil contract. The Division stated its concerns in a memorandum dated July 21, 1981, a copy of which was provided to GAO. The Division's concerns with respect to this proposed designation arose not as a result of a rule enforcement review, but rather as a result of the Exchange's handling of four recent referrals to the Exchange made by the Division. Accordingly, the Division believes the GAO Report should correct the misimpression that current evaluations of exchange programs can be obtained solely through rule enforcement reviews.

* * * *

In addition to these general observations on Chapter 7, the Division offers the following specific comments:

1. The GAO Report at page 105 states that "significant improvements have been made", yet nowhere in the introduction to the chapter is this conclusion mentioned. At the conclusion of the chapter, at page 131, the Report states only that reviews have improved "somewhat".

2. The Report at page 106 lists improvements in the rule enforcement review program proposed in 1979 by the Director of T&M, then goes on to state that only some of the improvements have been adopted. All of the improvements proposed, however, have been incorporated into the program, including reviewing the exchanges' original source material and reviewing areas not investigated by the exchanges, areas of improvement not recognized in the Report. In addition, as discussed above, the Report fails to note that the more recent reviews, although by necessity somewhat descriptive, assess the actual operational effectiveness of exchange programs.

3. Although page 106 of the Report states that reviews are "supplemented to some extent" by follow-up reports to the Commission, page 107 states that staff has not promptly followed-up on reviews. This criticism ignores, however, documentation provided to GAO which shows that staff diligently has followed-up on recent reviews. Specifically, GAO was provided with correspondence between staff and MidAmerica Commodity Exchange concerning certain recommendations made in the report to the Commission presented in July 1980, which correspondence reflected continuing concerns regarding the Exchange's disciplinary program and procedures regarding the use of the changer. In addition, upon the request of the Contract Markets Section, the Front Office Audit Unit, in the course of reviewing the office procedures of certain FCMs, reviewed whether those FCMs which also were members of MACE were complying with the new disclosure requirements concerning the changer fee. Through this follow-up, the Division has assured that all of the points noted in its review report on MACE have been addressed by the Exchange.

More recently, staff reviewed the implementation of the Coffee, Sugar and Cocoa Exchange's new computer surveillance system. This follow-up review was conducted because, at the time the Division presented its final report on this Exchange to the Commission, its computer program had not yet been implemented. An informational memorandum, dated October 14, 1981, describing the operations and capabilities of this new computer system, as well as some of its limitations, was sent to the Commission and a copy provided to GAO. See also comment No. 11 below.

4. As discussed in the Division's general observations, GAO notes at pages 107 and 122 of its Report that the current review of the CBT examines only two of eight subprograms in regulation 1.51. GAO neglects to mention, however, that the two subprograms examined are the two most important for an effective rule enforcement program and the two in which the Division found the CBT to be most deficient in 1978.

5. On page 108 of the Report, GAO presents some statistics representing staff years attributed to rule enforcement reviews. These numbers, however, fail to reflect time spent on examining the rule enforcement programs of NYFE, NOCE and the National Futures Association.

6. On page 110, GAO provides the Division's plan for rule enforcement reviews for fiscal year 1980. Although the chart makes clear that the anticipated schedule for completion was not met, it does not adequately reflect reasons for the delay. For example, at the beginning of FY 80 (October 1, 1979), the anticipated date for the review of NYFE was September 30, 1980, yet NYFE did not begin trading until August 7, 1980.

Moreover, as noted in the Division's general observations, a number of intervening events necessitated adjustments to the Division's plans.

7. At page 111 GAO relies upon a statement made by the "Associate Director" in stating that, although eight reviews are planned for FY 82, no exchanges have been selected. In fact, it was an Assistant Director, and he stated that although all eight reviews have not yet been planned, a number had been. For example--as GAO itself notes on the preceding page--a review of NYFE was begun in November, 1981 (FY 82). In addition, review of the KCBT and New York Cotton Exchange are in the preparatory stages.

8. At page 113, n. 1, GAO states that the rule enforcement procedures manual was finalized and adopted in late 1981. In fact, it was finalized and adopted in early 1981. In addition, it should be noted that the manual merely formalizes procedures which previously had been established.

9. At pages 115-119 GAO compares the review of the New York Mercantile Exchange with the results of an enforcement investigation. Our comments on these pages are provided above.

10. On pages 127-128, GAO discusses the question of one minute timing of trades. Contrary to the Report, opposition to one-minute timing was expressed by virtually all exchanges and, as recommended by the GAO in its 1978 report, the Commission did consider the feasibility of such a system. As stated by the Commission in the December 2, 1980 Federal

Register announcement of the adoption of amendments deleting the requirement of one minute timing and substituting a 30 minute bracketing requirement:

> The Commission's determination not to continue with one-minute timing as a requirement of its regulations is influenced considerably by the lack of evidence that technology is currently available to permit all of the exchanges to adopt one-minute timing systems and the concern that, absent such technology, the adoption of one-minute timing as an absolute requirement would invite major disruptions to the effective performance of the nation's commodity futures markets. Until such time as the Commission is persuaded that technological or other program or systems developments are capable of implementing more precise timing, timestamping or transaction sequencing systems, without posing a significant threat of market disruption, the Commission does not believe that a continued commitment to one-minute timing is in the public interest.

One minute timing is utilized currently by three of the smaller exchanges, the New York Mercantile Exchange, the Minneapolis Grain Exchange and in a modified form by the Kansas City Board of Trade. Thus, although one minute timing of trades would enhance the ability of the exchanges and others to reconstruct trading, the Commission's determination not to require one minute timing was based on its belief that current technology is inadequate to implement such systems without risk of disrupting current market activity. In addition, it must be remembered that the regulatory objective of obtaining accurate sequencing of trades would not be accomplished completely even with one-minute timing (particularly during active trading periods) and that one-minute timing would not be sufficient to detect all types of dual trading abuses.

COMMENTS RECEIVED FROM THE EXCHANGES AND OTHER PARTIES

	Page
Chicago Board of Trade	285
Chicago Mercantile Exchange	296
Coffee, Sugar, and Cocoa Exchange, Inc.	299
Commodity Exchange, Inc.	300
The Board of Trade of Kansas City, Missouri, Inc.	303
MidAmerica Commodity Exchange	305
New York Cotton Exchange	308
New York Mercantile Exchange	314
Kirkland and Ellis	316
U.S. Department of Justice	319

Chicago Board of Trade

Robert K. Wilmouth
President

March 15, 1982

Mr. Henry Eschwege
Director
Community and Economic Development
Division
United States General Accounting
Office
Washington, D.C. 20548

Re: Audit of the Commodity Futures Trading Commission

Dear Mr. Eschwege:

By letter dated February 19, 1982, you asked us to comment on those portions of your draft report on the Commodity Futures Trading Commission ("CFTC") which refer to the Board of Trade of the City of Chicago ("Board of Trade"). We appreciate this, and our comments follow.

Contract Approval and Review

The General Accounting Offices' ("GAO") analysis of the contract approval process is based on the premise that proposed new contracts should be held rigorously to the standards of the CFTC's Guideline I before they are approved. This is an erroneous premise, as the Board of Trade informed the CFTC when the CFTC attempted to codify Guideline I.[1]

Section 5(g) of the Commodity Exchange Act (the "Act") makes it a condition for designation as a contract market that transactions for future delivery in the contract will not be contrary to the public interest. Congress intentionally chose a very general standard when this section was added to the Act in 1974. The House of Representatives version of the Act, H.R. 13113, specified an economic purpose test as the standard for approval. However, the economic purpose test was purposely replaced by the "not

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[1] February 27, 1981 letter from Robert K. Wilmouth to the CFTC commenting on 45 Fed. Reg. 73504 (1980). [Attached.]

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contrary to the public interest" test in the final version of the Act. It is clear from the legislative history that Congress intended the marketplace to be the judge of the beneficial nature of a contract and intended that the Commission should deny designation only when there is evidence that a contract will be contrary to the public interest.[2]

One of the CFTC's earliest actions after its formation in 1974 was to release publicly a guideline, previously prepared by the staff of the old Commodity Exchange Authority, ("Guideline I") which proposed contracts must meet in order to be designated by the CFTC.[3] The Introduction to Guideline I sets out the following criteria for designation:

A. The board of trade must demonstrate that the existing or proposed contract meets the test of "economic purpose."

B. The board of trade must establish the commercial viability of the contract by justifying individual contract terms and conditions.

C. The board of trade must affirm that its designation or continued designation as a contract market will not be contrary to the public interest.[4]

Only the third of these criteria is in keeping with the requirement set forth in Section 5(g) of the Act that a proposed contract not be contrary to the public interest. The economic purpose and commercial viability tests were the result of a misinterpretation of Section 5(g) by the CFTC.

Guideline I is also contrary to the recommendation made in 1976 by the CFTC Advisory Committee on the Economic Role of Contract Markets. The Advisory Committee was composed of a distinguished panel of professional economists, cash market users and futures market professionals. The Advisory Committee recommended the adoption of a "why not?" test instead of a "why?" test because it realized that a "why?" test would, at best, be difficult to meet. In addition, the committee stated that: "The 'why?' test could seriously hamper the industry's development and even its current effectiveness by hampering innovation and adaptation to change."[5]

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[2] See H.R. Rep. No. 975, 93rd Cong., 2nd Sess., 29 (1974); S. Rep. No. 1194, 93rd Cong., 2d Sess., 36 (1974).

[3] Guideline on Economic and Public Interest Requirements for Contract Market Designation, Comm. Fut. L. Rep. (CCH) ¶6145.

[4] Guideline on Economic and Public Interest Requirements for Contract Market Designation, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,041.

[5] Report of the CFTC Advisory Committee on the Economic Role of Contract Markets, 8 (1976).

An industry wide group, of which the Board of Trade is a part, has proposed that §5(g) of the Act be amended to replace the "public interest" test with a "hedging or risk management" test.[6] Exchanges have a vested economic interest in designing the best possible contracts. Much time and money is spent by exchanges in designing new contracts and attempting to write contract terms that will meet the needs of the commercial market. Contracts which do not serve the needs of the public simply do not succeed. The judgment of regulators in trying to predict the success of new economic activity is a poor substitute for the judgment of the marketplace.

The Board of Trade would also like to correct several misleading statements in the draft report. The most glaring error is a statement that "the Chicago Board of Trade's Financial Instrument Group Manager told us that exchange responses should be subject to a deadline." The Financial Instruments Group Manager actually said that the CFTC should be subject to a deadline for raising objection to the contracts submitted by the exchanges; she did not say that the exchanges should be subject to a deadline.

The report states that exchanges have been slow to respond to CFTC requests for information regarding contract submissions. The Board of Trade makes every effort to comply with the CFTC's requests for information in a timely manner. Many of these requests are satisfied by telephone calls which may only later be reduced to written form. More importantly, many of the CFTC's requests are for information which the Board of Trade has not compiled because the Board of Trade's economists have made a reasoned judgment, based on experience, that the information is of little use for designing a contract or estimating its economic usefulness. It is understandable that the Board of Trade cannot gather such information overnight. It is in this context, and this context only, that a Board of Trade economist told the GAO auditors that the exchange has to expend much time and many resources to answer the CFTC's queries. Moreover, it sometimes happens that the CFTC tells us that actual contract rule changes are needed before they will complete processing of an application for designation. Often we feel that these changes are not necessary, but we accede to these requests because there is no practical alternative. In these instances the rule changes must be approved by our relevant product committee and the Board of Directors, and this process does take time.

Market Surveillance

The portion of the GAO draft report on the need for large trader positions is also based on an erroneous premise. GAO assumes that large trader positions are required on a routine basis in order to run an effective market surveillance program. The Board of Trade has already commented on this matter in detail.[7] However, we will reiterate our comments here.

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[6] See testimony of Robert K. Wilmouth before the Subcommittee on Agriculture Research and General Legislation of the Senate Committee on Agriculture, Nutrition and Forestry (March 1, 1982).

The Board of Trade feels that an effective market surveillance program is one which is sensitive to price distortions and is capable of discovering, in most instances, whether such distortions are due to natural or unnatural causes. Large trader information is needed only after it has been determined that price distortions are due to unnatural causes.

Large futures positions are not evils in themselves. Many times such positions are the result of legitimate business decisions and valid economic purposes. Even if they are not the result of economic purposes which the CFTC views as valid, they cannot adversely affect the marketplace without first distorting prices unnaturally. The staff of the Board of Trade monitors for any indications of an incipient price distortion -- that is, price movements not caused by natural market forces or underlying fundamentals in the cash market. If such price movements are noted, the size of positions held in the market may be ascertained and investigated to see if there are any large positions which have no apparent economic validity or which were taken for the purpose of contributing to the price distortion.

The Market Surveillance Section at the Board of Trade monitors price movements and changes in price relationships on a daily basis. The Section compares these price movements with cash prices and prices of similar commodities on other exchanges. If the prices in the various markets (including the cash market) tend to track each other, and the arithmetic difference between such prices bears some reasonable relationship to the basis, no price distortion exists and no further action need be taken.

Similarly, the Section monitors spread relationships to determine whether or not price distortions exist in the deferred contract months. If spread prices bear some reasonable relationship to carrying charges, no price distortion exists and no further action need be taken.

If it appears that prices do not reflect a reasonable relationship with the basis or carrying charges, the Section analyzes additional information to determine whether such apparent distortion is due to natural or unnatural causes. Some of the information utilized to make this determination is supply and demand factors (stocks, deliverable supply, projected supply, price levels of substitutable commodities, export figures, projected demand and transportation availability), prior history information concerning historical price movements (as well as deliverable and non-deliverable stocks and open interest), volume and open interest, seasonal factors, national and world events, and rumors. After reviewing and analyzing this information, the Market Surveillance Section can determine whether or not the apparent price distortion can be attributed to natural causes.

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[7] See letter dated November 21, 1980 from Robert K. Wilmouth to the CFTC commenting on 45 Fed. Reg. 57141 (1980). [Attached.]

Only after it has been determined that price distortion cannot be attributed to natural causes is large trader information required.

The Board of Trade currently reviews the positions of clearing members on a daily basis in compliance with the CFTC's guidelines.[8] The Board of Trade compliance staff receives major market participant computer runs which list gross positions of clearing members, grouped by house and customer accounts, and adjusted net position runs which show net positions of these same clearing members by house and/or customer accounts. By reviewing this information, the Market Surveillance Section can note large concentrations of positions among clearing members. When required, these clearing members are contacted and asked to provide a breakdown of these positions by account ownership.

The other source of large trader information is the CFTC itself. Congress anticipated and authorized this information sharing procedure in §8a(6) of the Commodity Exchange Act which authorizes the CFTC to provide this information to the exchanges on a confidential basis when, in the CFTC's judgment, the information relates to any transaction or market operation which "disrupts or tends to disrupt any market or is otherwise harmful or against the best interests of producers and consumers."[9] In order to better implement this provision, the Commission has adopted Regulation 140.72.[10] The Board of Trade has, as required by Regulation 140.72, provided the Commission with a list of persons authorized to obtain this information for the Board of Trade and has requested and received this information when it was believed necessary.

Routine large trader monitoring by the exchanges is neither efficient nor effective, especially in light of its limited usefulness for market surveillance purposes.

The CFTC's jurisdiction is far more encompassing than that of the exchanges. The exchanges have no enforcement powers over non-member omnibus accounts, for instance, while the CFTC has enforcement powers over all FCMs. The exchanges could, of course, try to enforce reporting requirements for non-member omnibus accounts by ordering member firms to refuse to carry any omnibus account which does not report, but such enforcement efforts would be time consuming, indirect and not necessarily effective. The exchanges would have major problems obtaining access to books and records giving details of a non-member omnibus account in order to make a determination as to whether or not is it carrying any reportable positions. Therefore, violations would be almost impossible to detect. Even if violations were detected and member firms were ordered not to carry the account, the traders acting through omnibus accounts might be able to conceal their identities in ways that the exchange would not be equipped to detect.

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[8] Guideline 2, Comm. Fut. L. Rep. (CCH) ¶6430.

[9] 7 U.S.C. 12a(6).

[10] 17 C.F.R. §140.72.

Aggregation of positions of large non-member traders is another problem that the exchanges cannot deal with effectively. The exchanges would find it impossible to monitor the aggregate positions of large traders without the use of a single uniform identification number for each trader: a proposition which is unworkable.[11] Even if exchanges had the ability to monitor aggregate positions, enforcement of reporting requirements by large non-member traders would be impossible for the same reasons that reporting by non-member omnibus accounts would be hard to enforce. Additionally, a trader could easily conceal his identity from the exchange and continue trading without any fear of sanction if he is caught. The exchange cannot threaten non-members with criminal sanctions, fines, suspensions or expulsion. The exchange's sole remedy is to liquidate the trader's positions (if they can be discovered). Considering that these are large positions, liquidation could disrupt the market with potential enormous harm to the markets, other traders and potential customers. Obviously, the CFTC has a choice of less drastic remedies in these situations.

The CFTC also has the advantage of gathering position information on all exchanges and aggregating positions in the same commodity on different exchanges. The exchanges do not have this advantage. The Board of Trade would, in fact, strenuously object to sharing data obtained by it with other exchanges except under extraordinary circumstances. Increasing the bodies with access to information makes it more likely that leaks of the information will occur, however innocent. The Board of Trade submits that such sensitive information should be submitted to the CFTC alone, and that it should be released to other exchanges only on an extraordinary basis, and only after the CFTC has determined that such information is vital to the protection of the marketplace.

Finally, the exchanges cannot implement a routine large trader monitoring system without an expenditure of resources vastly greater than any potential benefit. Under the present system, series '01 reports are filed with the CFTC by futures commission merchants ("FCMs") for each account, or group of related accounts, carried for others with a reportable position in any one future of any commodity on any one contract market. The first time an account, or group of related accounts, reaches a reportable position in any commodity, the FCM must also file a Form 102 with the CFTC. On Form 102 the FCM identifies the account, or group of related accounts, and assigns it an identification number to be used on all series '01 reports. These accounts have to be identified manually as related accounts before the computer can be programmed to aggregate them.

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[11] See industry comments to 42 Fed. Reg. 55538 (1977).

In order to even approach a system similar to that presently in operation at the CFTC, the Board of Trade would have to make significant expenditures for additional staff, staff training, and computer software. We do not have a firm estimate of what this would cost the Board of Trade, nor can we ascertain from public records what the CFTC spends to perform this function, although it appears to be a significant expense. We assume, after an initial start-up and shakedown period, that the costs for the Board of Trade would be similar to those of the CFTC.

The CFTC already has the staff, the training, and the expertise to process large trader data. To expect each exchange to duplicate this effort is unreasonable, and to expect them to replace it is unrealistic. We assume that there are economies of scale in having one such reporting system run by the CFTC, over many such systems as would be required if each exchange had a similar program just for itself.

Several statements made by GAO in its draft report need correcting. First of all, the Board of Trade does *not* take a laissez-faire approach to market surveillance. The GAO auditors must have misinterpreted comments made by our head of market surveillance. The Board of Trade takes a very methodical approach as explained above.

The Board of Trade's market surveillance system works, as evidenced by the 1979 March wheat market and the 1980 silver market. In the first case, following a CFTC declaration that an emergency existed, a federal district court found that no emergency, including any major market disturbance, existed in the March '79 wheat contract.[12] In the second case, the CFTC itself concluded that the Board of Trade acted properly.[13]

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[12] See March 18, 1979 order by Judge Grady in Board of Trade of the City of Chicago v. Commodity Futures Trading Commission, 79 C 1068 in the United States District Court for the Northern District of Illinois, Eastern Division. *Reversed on other grounds*, 605 F. 2nd 1016 (7th Cir. 1979), *cert. denied*, 446 U.S. 928 (1980).

[13] Silver Futures Study, Commodity Futures Trading Commission Report to Congress (May 29, 1981).

Mr. Henry Eschwege March 15, 1982

Exchange Self-Regulation

The draft audit report implies that the Board of Trade's rule enforcement programs are inadequate and have been so consistently since the CFTC's 1977-78 rule enforcement review of the Board of Trade. This implication is untrue and is unfair to both the Board of Trade and the CFTC.

The Board of Trade has made substantial changes to its programs and procedures since the 1977-78 review.[14] It has developed a number of computer programs designed to provide the enforcement staff with information which is easy to comprehend and interpret. Some of these computer runs are generated and reviewed daily and others are generated on an "as needed" basis. Among these runs are a monthly report showing bracketing accuracy levels for individual members and member firms and two runs showing positions for market surveillance purposes.

On January 16, 1979, the Board of Trade adopted disciplinary rules which it believed complied with Part 8 of the CFTC's regulations. The CFTC and the Board of Trade disagreed on the interpretation and intention of several of these rules. After prolonged negotiations broke down, the Board of Trade substantially revised the new disciplinary package on March 19, 1981. The CFTC approved these rules on July 29, 1981 and the Board of Trade has been operating under them since August 17, 1981.

Two other changes have taken place since the 1977-78 review. The enforcement staff has taken more initiative in initiating investigations and developing evidence, and the investigative reports contain more complete information, including a list of relevant rules.

Some of the matters critized by the CFTC in its 1977-78 review have not been changed in any major respect, nor has the CFTC expressed further concern about these areas. We believe that these programs are adequate and effective in their present form for reasons which the Board of Trade has expressed to the CFTC.[15] We have apparently convinced the CFTC of the adequacy of these programs. A discussion of some of those areas follows.

The CFTC stated that the Business Conduct Committee must stop "delegating its rule enforcement responsibility to member firms that were perceived to have an effective rule enforcement program." The Committee does not "delegate" its responsibilities to anyone. Rather, it takes into account whether a particular program of internal controls complies with Exchange requirements. We know of no entity with prosecutorial powers that does not consider the same factor in deciding whether to bring an action or, once instituted, in deciding upon an appropriate remedy. See, for example, Section 13(b) of the Act.

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[14] See letters from Robert Wilmouth to Terry Claassen dated March 14, 1978; April 17, 1978; and October 30, 1978. [Submitted under separate cover.]

[15] See March 14, 1978 letter, *id.*

Any truly effective rule enforcement program must offer positive encouragement for members and member firms to make the substantial commitment necessary to assure compliance in their own business activities. The dread of prosecution alone is not always the most effective tool. By acknowledging the efforts of member firms in pursuing effective internal compliance, this Exchange gives support to those efforts. We would not want, therefore, to ignore a good performance record or to consider it irrelevant in fashioning appropriate remedies.

The CFTC cited an evident "communication barrier" between the Exchange and the Board of Trade Clearing Corporation. Again, this conclusion was apparently based upon incomplete facts. The kinds of information maintained by the Clearing Corporation have the highest imaginable market sensitivity and, for that reason, the Clearing Corporation prudently expects that requests by the Exchange for that data will follow defined lines of authority. At the same time, however, the Clearing Corporation does not withhold trade data information when properly requested.

The CFTC also indicated that greater surveillance of deferred futures should be undertaken by the Exchange. We endeavor to be alert to the conditions in all futures contracts, nearby or deferred, but our primary commitment of resources is necessarily in the nearby months where, because of delivery potential, the risks of default or market manipulation are far greater than in more distant months. To devote comparable attention to all open futures contracts would not be an efficient use of exchange resources. The Business Conduct Committee does, however, give serious attention to deferred futures.

The CFTC suggested a lack of surveillance procedures "tailored" to the unique characteristics of each commodity. There is a wealth of information utilized by the Exchange in its surveillance activities that is necessarily tailored to each commodity. Silver futures contracts involve quite different information from wheat futures or GNMA contracts. On the other hand, the dynamics of the futures market are not significantly different from the one commodity to another, as witness the ease with which traders can move from one commodity to a far different one. For example, the factors leading to a potential price manipulation are essentially the same for wheat, gold, GNMAs and plywood. Thus while the "fundamentals" of each commodity may differ, market activity is quite similar for all commodities and, for that reason, the surveillance program need not change drastically from one commodity to another.

Finally, the CFTC questioned the effectiveness of the Board of Trade's disciplinary actions. The effectiveness of the Exchange's disciplinary actions cannot be judged accurately by mere reference to the number of investigations opened versus the number of penalties imposed. Every item that is examined or reviewed, including all customer complaints is assigned an investigative number, and the great majority of these matters involve no real possibility of punishable rule violations. A more appropriate analysis for purpose of assessing disciplinary effectiveness would be to identify those investigative files where significant suspicion of rule violations is present, and to trace how those specific cases are resolved. If this were done, we believe that the CFTC's conclusion would have been quite different.

The CFTC has also suggested that the Exchange adopt a uniform standard for evaluating evidence. We were unclear as to the meaning of this observation. Evidence was and is evaluated for accuracy, sufficiency, credibility, and probative value, as in the case of all other judicial proceedings. Exchange disciplinary proceedings fall somewhere between purely civil and purely criminal actions. Thus, the appropriate standard of proof (which is different from standards for evaluating evidence) is whether the "weight of the evidence" supports a finding of violation [see §§6(a) and 6(b) of the Act], and this is the measure utilized throughout the Exchange's disciplinary system.

The GAO draft report states that Trading and Markets typically does not perform prompt, substantive follow-ups to assess whether or not exchanges have acted to correct deficiencies noted in earlier reviews. It has been the Board of Trade's experience that staff members from the Chicago office frequently review Board of Trade committee minutes and investigative files and discuss market surveillance matters with our staff.

We cannot comment on the CFTC's latest rule enforcement review since we have not seen the report, although the CFTC has said we would have a chance to review it and comment on it before it is put into final form.

Finally, we note that it is the nature of an audit to find and report on errors. As the GAO knows, the mere fact that a number of errors were mentioned in the CFTC's 1978 report does not mean that the Board of Trade's programs were generally inadequate. The degree of involvement by the public in our markets proves that our markets work and enjoy public confidence.

Arbitration

The draft report gives the misleading impression that the Board of Trade has been recalcitrant in meeting its obligations under §5a(11) of the Act and Part 180 of the Commission's regulations. The Board of Trade has made every effort to cooperate with the CFTC and to comply with the law.

Neither §5a(11) nor Part 180 compels an exchange to require its members to arbitrate customer disputes, and the Board of Trade has consistently maintained that the CFTC cannot force an exchange to do so. This position has been vindicated by the United States District Court for the Northern District of Illinois which just recently decided that the CFTC's position would violate the Seventh Amendment right to a jury trial.[16]

The arbitration rules currently in effect at the Board of Trade fully comply with Part 180 and our mailings now inform customers of their right to a mixed panel. The mixed panel rule was adopted by the Board of Trade on February 15, 1977 when Part 180 became effective and was submitted to the CFTC for approval as part of a complete package of arbitration rules. The CFTC treated the package as a unit and apparently decided not to approve any of it until the dispute over mandatory member submission to customer initiated arbitration proceedings was resolved. The CFTC finally approved those rules which were not in dispute. However, the only regulation which could have been used to limit the Arbitration Committee's jurisdiction to disputes arising out of business transacted on the Board of Trade (Regulation 640.04) was not approved.

On January 20, 1981, the Board of Trade submitted a non-controversial amendment to its definition of "claim or grievance" in Regulation 603.01(B) and made a decision not to put the customer portions of the new arbitration package into effect until this amendment was approved. To have put the rest of the customer rules into effect without a rule limiting jurisdiction could have resulted in a backlogged calendar and a morass of unwanted jurisdiction over claims arising out of transactions on other exchanges. The staff of the CFTC was told of the Board of Trade's decision in February, 1981 when the Administrator of Arbitration initiated a call to the Division of Trading and Markets to inquire about the status of Regulation 603.01(B).

The CFTC approved the amendment to Regulation 603.01(B) on December 9, 1981, and the customer arbitration rules were put into effect by the Board of Trade on January 1, 1982.

The arbitration rules which were in effect until January 1, 1982 comported with due process and were comparable with the rules of other arbitration forums. No customer has received an unfair hearing due to the use of the old rules.

Again, we thank you for the opportunity to comment on certain sections of the GAO report. We trust that our comments will be helpful in the preparation of the final report.

Very truly yours,

R K Wilmouth

Robert K. Wilmouth

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[16] Board of Trade of the City of Chicago v. Commodity Futures Trading Commission, 81 C 7175, February 25, 1982 Transcript of Proceedings at pgs. 51-59.

CHICAGO MERCANTILE EXCHANGE
International Monetary Market Associate Mercantile Market
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March 19, 1982

Mr. Henry Eschwege, Director
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Eschwege:

The Chicago Mercantile Exchange ("Exchange") appreciates the opportunity to comment upon the document which was sent to the Exchange by the General Accounting Office ("GAO") and which consists of portions of the GAO draft report, entitled "Commodity Futures--Rapid Growth Requires Improved Federal and Industry Roles" ("draft report"). The Exchange specifically wishes to comment on the portions of the draft report addressing the Commodity Future Trading Commission ("CFTC") contract approval and review process, market surveillance, and rule enforcement reviews.

I. Contract Approval and Review Process: Affirmation of Public Interest

The draft report suggests that the CFTC has been too passive in its development of one of its duties regarding contract approval. The report indicates that the CFTC should be developing "a more meaningful public interest test" than its current test of determining whether proposed contracts "are not, or are not reasonably expected to be, contrary to the public interest." The statement of an Exchange vice president that "the public interest test requires only sound contract terms and conditions" is then offered, presumably as support of the lack of a meaningful public interest test. The Exchange disagrees with the assessment that the CFTC should be more active in this area and believes that the Exchange's position with respect to sound contract terms and conditions is sufficient to satisfy the congressional mandate.

The CFTC applies a standard which requires a showing that a contract will be or is expected to be used for hedging or price-basing. Part of the Exchange demonstration of "sound contract terms and conditions" is a showing that the contract conforms to commercial practices in such a way that it will reasonably be expected to be used for hedging or price-basing. Sound contract terms and conditions also are a requirement for a showing that the contract is not subject to conjestion or manipulation. In effect, then, the demonstration of "sound contract terms and conditions" would encompass a showing that the contract would not be contrary to the public interest.

II. Market Surveillance

The draft report refers to the 1980 rule change proposed by the CFTC whereby exchanges would collect, process and submit large trader data to the CFTC.

LONDON 27 Throgmorton Street EC2 NEW YORK 67 Wall Street 10005 WASHINGTON, DC 1101 Connecticut Avenue N.W. 20036

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Mr. Henry Eschwege
March 19, 1982
Page Two

However, it is not clear why this reference was included in the draft report. Nevertheless, the Exchange wishes to reiterate its position that the CFTC's involvement in this area should be one of oversight, not one of prescribing the collection, processing and submission of large trader data, which could ultimately lead to the CFTC's direction of the market surveillance itself. Effective monitoring can best be achieved through the efforts of the exchanges.

The Exchange has had significant success in monitoring the markets through its surveillance program. This program has been continuously updated and revised to maximize the effectiveness of the Exchange's surveillance methods. The program has continued to improve and, in many ways, has more stringent requirements than those of the CFTC. For example, pursuant to Regulation §15.03 of the Commodity Exchange Act, the CFTC requires reporting of large positions, frequently 100 contracts or more, for various commodities but the Exchange requires reporting of any position of at least 25 contracts in a contract month in every commodity. Additionally, the Exchange is authorized to require reporting of a lesser number of contracts if such a need exists.

Among the reasons that the Exchange can more effectively monitor its markets than can the CFTC, are the following: First, the Exchange has greater familiarity with its members and clearing members than does the CFTC. Therefore, unusual trading patterns or positions would be more apparent to Exchange staff than they would be to CFTC staff. Secondly, the Exchange, being charged to monitor itself, could clearly focus its energies more effectively and could concentrate its efforts to a much greater degree than could the CFTC, which is responsible for monitoring all contract markets as well as non-exchange members.

Finally, it should be noted that the Exchange clearly recognizes the importance of market surveillance. The draft report states that "the Head of Market Surveillance" at the Exchange "told us the exchange views market surveillance and the protection of market integrity as an important marketing tool, i.e., a way of fostering public confidence in its markets." This statement has been taken out of the context of the discussion with your Office. Rather than emphasizing the marketing benefits of an effective market surveillance program, the Head of Market Surveillance stated that a side benefit of an effective and aggressive market surveillance program can be a sound basis for public confidence in the market. It is true that since public confidence increases participation, the Exchange membership has sound business reasons for supporting a strong market surveillance program. Public confidence is to some extent a motivating force as well as an end result of the market surveillance program.

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Mr. Henry Eschwege
March 19, 1982
Page Three

III. "Comparison of Findings of Rule Enforcement Reviews 1976-1981"

A. Record Keeping Requirements

The Exchange also wishes to comment upon the CFTC findings regarding record keeping requirements pursuant to §1.51(b), as reported under GAO's "Comparison of Findings of Rule Enforcement Reviews 1976-1981." The Exchange has never been informed of the "serious deficiencies" findings of this aspect of the third rule enforcement review, is unaware of the reasons for this finding and is therefore unable to address any specific issues which might fall within this aspect of the review except to assert that we do not have serious deficiences in complying with record keeping requirements and are prepared to demonstrate the quality of our record keeping.

B. Bias of Reviews

The categories used to evaluate the performance of the Exchange in the areas examined clearly represent a bias against the Exchange or the industry. Under the scheme presented to us, areas of the Exchange's program could only be found to be "adequate," to have "serious deficiencies," or "to be much improved and now in compliance." There is no category for a performance that might be "outstanding," "excellent," or even "good." In effect, the analysis is seriously skewed; there is no possibility to report a commendable performance by the Exchange. This patently unfair "test" is clearly indicative of a strong bias and therefore serves to undermine the credibility and value of the entire draft report.

Again, we appreciate the opportunity to comment upon GAO's draft report.

Very truly yours,

Beverly J. Splane
Executive Vice President

BJS:djb

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Coffee, Sugar & Cocoa Exchange, Inc.

March 10, 1982

Mr. Henry Eschwege, Director
Community and Economic Development Division
United States General Accounting Offices
Washington, D.C. 20548

Dear Mr. Eschwege:

We have reviewed the drafts that accompanied your letter to me dated February 19, 1982. A comparison has been made to your data, and information in Exchange records, and we believe the two are consistent with the exception of those items that have been noted on the "Amended" draft attached.

May we further add that due to the complexity of some of the issues involved and philosphical interpretations, we did not fully agree with the Commission's analysis in certain areas.

We appreciate the opportunity to reviewing your preliminary findings and look forward to responding to any further request you may have for information in this area.

Sincerely yours,

Bennett J. Corn

Bennett J. Corn
President

BJC/lav

attached

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COMMODITY EXCHANGE, INC.
FOUR WORLD TRADE CENTER
NEW YORK, NY 10048

OFFICE OF THE
PRESIDENT

(212) 938-2900
TELEX 12-7066

April 6, 1982

Mr. Henry Eschwege, Director
Community and Economic Development Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Eschwege:

Commodity Exchange, Inc. ("Comex") is pleased to have the opportunity to comment with respect to the portions of the draft report entitled "Commodity Futures -- Rapid Growth Requires Improved Federal and Industry Roles", which you forwarded to us. However, we regret that we were not able to review the entire report, since the context in which the information in those excerpts we received will be presented is not always clear. It must be understood, therefore, that our comments are based only on the portions of the report we reviewed, and we cannot say with certainty that they would be the same if we had reviewed the entire draft report.

Market Surveillance

In its discussion of market surveillance, the report states that a large trader reporting system is an integral part of an effective surveillance program. It then notes that "the market surveillance directors at the Commodity Exchange, Inc. ...told us that when they need large trader data they contact the CFTC." This latter statement has not been accurate for some time.

First, it must be recognized that Comex always has had the authority to obtain position data when a need exists, and that this authority has been exercised on numerous occasions in the past. For example, in January 1980, the Comex Board of Governors adopted rules requiring each member firm to file a report on any account which it maintained for itself or for a customer and which contained open positions in silver or copper exceeding established reporting levels. The Comex Director of Market Surveillance frequently compares

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and discusses with his counterpart at the CFTC position data which they have both obtained relative to certain large positions.

In April 1981, the Comex Board adopted proposed Rule 523, establishing comprehensive and uniform reporting requirements, and submitted this rule to the Commission for approval. Before the Commission had an opportunity to act, the Board, in February 1982, amended the rule once again, to make it applicable to futures options. In addition, the Board exercised its authority under the proposed rule to reduce the reportable position level from 500 to 250 contracts. These most recent amendments are waiting approval of the Commission.

Comex agrees that a large trader reporting system is an integral part of an efficient market surveillance program and believes that its revised reporting system will improve the collection of data and more effectively enable the Exchange to prevent any untoward price distortion and to provide an orderly marketplace.

Rule Enforcement Review

In the discussion of the Commission's rule enforcement review program, the report states that "[i]n the case of the Comex, the Commission designated two contracts after two successive rule enforcement reviews had disclosed serious deficiencies in the exchange's compliance program." An accompanying chart summarizes the findings of the CFTC in three rule enforcement reviews and, again, notes that the Commission found "serious" deficiencies in the Comex rule enforcement program.

Comex strenuously objects to the use of the term "serious" with respect to the description of the deficiencies found in the Comex program. This term is not used by the Commission and its use in the report is totally unfounded.

Further, while Comex does not deny that the Commission did find problems with the Exchange's rule enforcement program, the recitation of this fact alone does not accurately describe the Commission's findings. We believe it is equally important for this report to note that the Commission also found that, in the performance of its self-regulatory responsibilities,

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Mr. Henry Eschwege, Director
April 6, 1982
Page Three

Comex has shown steady progress. For example, in a letter to Comex dated July 29, 1979, the Commission stated:

> However, we believe that the Exchange has shown substantial progress since the last review in 1976, and that the Exchange had established the foundation for an effective rule enforcement program during the target period.

Again in 1981, the Commission found "that the Exchange generally is in compliance with Commission regulation 1.51."

In addition, the report fails to mention a 1980 rule enforcement review of the Comex audit and financial surveillance program. The report of that review, released in July 1980, disclosed that Comex "has developed a sound approach for carrying out its responsibilities in those areas. The program is generally satisfactory, and the overall execution of the program has been good."

By unilaterally choosing to characterize the deficiencies found in the Comex rule enforcement program as "serious" and by failing to note the progress which Comex has made, and is continuing to make in its rule enforcement program, the draft report misrepresents the findings of the Commission and should be corrected.

We hope these comments have been helpful and regret the delay in forwarding them to you.

Very truly yours,

Alan J. Brody
President

AJB:lod
Cc: Ralph Lowry, Senior Evaluator
Lee H. Berendt
William E. Seale
John F. O'Neal, Esq.

THE BOARD OF TRADE
of
KANSAS CITY, MISSOURI, INC.
SUITE 274 • 4800 MAIN STREET • KANSAS CITY, MISSOURI 64112
(816) 753-7500

March 12, 1982

Mr. Henry Eschwege, Director
Community and Economic Development Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Eschwege:

Mr. Paul Beyer, President of the Kansas City Board of Trade, gave me your letter of February 19, 1982, to answer. Incidentally, it was received on March 1, 1982.

The matter referred to in Column 3 of Page 250 of the draft document was first investigated by the staff of the KCBOT and was triggered by complaint filed by a member. The transaction in question only involved one or at most two traders in a deferred month and it's deemed of minor consequence. The matter was ultimately settled by a member paying a fine, although admitting no guilt. In short, far too much is being made of a fairly unimportant event(s). Moreover, to the extent changes were suggested, the KCBT made same.

The CFTC also has serious questions about the method several exchanges use in settling settlement prices because the CFTC believes in elimination of all member discretion whereas this exchange feels that any set mathematical formula is susceptible to manipulation, once known, whereas a system such as we use for wheat relies upon the skill and judgment of dedicated and experienced committee chairman and members, and is more reliable and much less apt to be used in some improper manner.

We have not seen any ultimate document which reached the conclusions listed in the document we have "Comparison of Findings of Rule Enforcement Reviews 1976-1981." We would be most distressed if the informal conclusions reached by CFTC staffers without benefit of discussion with exchange officials were utilized in any document going outside the Agency. This is somewhat like trial by press where the allegedly improperly acting party has not had an opportunity to present material contrary to the material presented by the "prosecutor".

In effect, in our judgment, this is tantamount to utilizing material from a police investigative file which at best is raw data subject to analysis only by investigators and has not been reviewed in any objective sense by any trier of facts.

GAO note: Page numbers referring to our draft report have been changed to refer to the final report.

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Page 2
Mr. Henry Eschwege
March 12, 1982

The Commission has advised us regarding some of their views, and in response, the market has initiated additional procedures to follow in conjunction with the closing prices. If you are going to carry the material indicated, at the very least you should indicate that the Exchange did make some changes in response to the CFTC criticism, although denying that there was any substantial problem in existence.

Further, we feel it somewhat unfair and incomplete to write a report without ever having visited the exchange.

I trust this is somewhat responsive to your letter of the 19th of February. I may supplement these remarks or questions by telephone calls to some of the persons listed in the letter.

We do appreciate some opportunity to attempt to at least moderate the record although it is not clear to us to what extent, if any, our remarks will be utilized.

Very truly yours,

W N Vernon III

W. N. Vernon III
Executive Vice President
and Secretary

WNV/eo

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MidAmerica Commodity Exchange

The Marketplace for MiniContracts
175 West Jackson Boulevard
Chicago, Illinois 60604
(312) 435-0606

March 8, 1982

Mr. Henry Eschwege
Director
Community and Economic Development Division
United States General Accounting Office
Washington, D.C. 20548

Re: CFTC Review

Dear Mr. Eschwege:

This is in response to your letter of February 19, 1982, regarding your draft report entitled, "Commodity Futures--Rapid Growth Requires Improved Federal and Industry Roles." In your letter you solicited comments on your draft. We are pleased to respond as follows:

In Chapter 3, discussing the quality of exchange applications for designation as a contract market, your draft states:

> For instance, a MidAmerica Commodity Exchange Vice President stated that his exchange does not submit contracts to the CFTC until they are ready to trade (emphasis supplied).

I believe that it would be more correct to paraphrase my remarks on this subject to say that MidAmerica does not submit contracts until the applications conform to Guideline I.

More generally, on the subject of the quality of exchange applications, I believe that the charge of "inadequate" applications is easily levied, but not well founded. As I indicated in earlier discussions with GAO, MidAmerica makes a point of submitting its applications only when they are fully developed. Indeed, CFTC staff members have advised us orally that they do not believe MidAmerica's applications are of such a quality that they believe that we specifically are guilty of rushing for a place in line. Believing us to be not among the accused, I believe I can comment objectively on Economics & Education's charge of inadequate applications. From our observations, the quality of an application does not seem to relate substantially to the speed with which an application is approved. For example, Economics & Education, in recommending approval of the New York Futures Exchange's foreign currency contracts noted that "... the evidence invoked to support... [an economic purpose] conclusion is somewhat weak ..." (emphasis supplied). Indeed, Economics & Education largely rejected the arguments proffered by the NYFE, ultimately putting "... important emphasis on those NYFE contract provisions and Exchange facilities which conceivably could enhance the attractiveness of currency futures for hedging." Notwithstanding the impediments of "somewhat weak" evidence of economic purpose, Economics & Education managed to complete its review of five NYFE currency contracts in just short of 11 months.

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Other applications, comparatively well documented in the same area, are tied up for months, or even years. MidAmerica's T-bond contract took almost one year to be approved while its T-bill contract has languished for nearly 900 days. Notwithstanding Chairman Johnson's efforts to clear the docket of pending applications, the situation does not seem to have improved uniformly of late. In August, 1981, we filed a particularly well documented application for domestic refined sugar; but, nine and one-half months later, we are still waiting for our first substantive reply from Economics and Education. It seems to us that the "quality" of applications lies in the subjective eye of the beholder, and that often solicitations for more information are poorly based in economic theory or practicality.

Your draft states in part:

> In other cases, according to the Deputy Director [of the Division of Economics and Education] exchanges have simply copied a competitor's contract and submitted it to CFTC. The Deputy Director stated that when CFTC requested additional information on such contracts, the exchanges either had difficulty developing such information or assigned a low priority to formulating a response.

While such a situation might arise from time to time, we doubt that it is, in the main, a valid charge. In most situations where one exchange has copied the contract terms of another exchange, the "information on such contracts" is readily available to the interloping exchange. Indeed, in order to develop submissions and respond to CFTC requests for information, MidAmerica maintains a Department of Economic Research to identify such information, both independently and from such sources as the CFTC itself and other exchanges. To the contrary, one would think that since the CFTC staff is already familiar with the relevant issues (having approved the first contract in a particular commodity) that it would be relatively easy to review quickly the same issues for the new application. Unfortunately, our experience suggests that for some mysterious reason it often takes longer to approve a well documented application for a contract similar to one already actively traded than it takes to approve novel applications of other exchanges. For example, the Minneapolis Grain Exchange's novel sunflower contract was approved in 12 months whereas the subsequent approval of the Chicago Board of Trade sunflower seed contract took 22 monhts.

Your draft pointed out that for three of the ten contracts the GAO examined, exchange replies were slow in coming (from three months to over a year). In some cases, exchanges are delayed in responding due to the press of other business. But in others, the amount and type of information requested by the CFTC requires a great deal of time to prepare. When such information contributes meaningfully to the evaluation of the contract, we are pleased to respond. However, often the requested information is already known, or should be known, to the CFTC, or would in no meaningful way contribute to the public interest. In such cases, we wonder whether the fault should be laid at the door of the exchange or of the requestor of the superfluous information.

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Finally, you observed that the new chairman of the CFTC regarded the problem of exchange responsiveness for additional information within 90 days. Depending upon the nature of the requested information, this is typically not an unreasonable period of time. However, parity as well as practical experience suggests that the Commission, too, should respond to exchange submissions within a corresponding period of time.

We very much appreciate the opportunity to participate in your review of the CFTC, and hope that our input has in some way proved helpful. Should you have any questions with respect the foregoing, please do not hesitate to contact me.

Sincerely,
MIDAMERICA COMMODITY EXCHANGE

Mark K. Bruscke
Vice President & Treasurer

MKB/ar

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New York Cotton Exchange
New York

March 10, 1982

Mr. Henry Eschwege, Director
United States General Accounting Office
Washington, DC 20548

Re: Your letter of February 19, 1982

Dear Mr. Eschwege:

We have reviewed the captioned letter as well as the excerpts of your report cited therein.

For ease of presentation, we have added a "Rider 1" to your first point concerning our discussions with the CFTC with respect to the Exchange giving the " . . . CFTC notification of [possible] violations of CFTC rules when they were discovered during the exchange's audits of FCMs . . . "

Similarly, with respect to your chart "Comparison of Findings of Rule Enforcement Reviews 1976-1981", we have added "Rider 2".

The purpose of "Rider 1" simply is to assure that the tone and purpose of the Exchnage's discussions with the CFTC on the question of reporting potential Rule violations is adequately addressed. Our view in reading the report as written is that it makes the Exchange's discussions with the CFTC on this matter more adversarial than they were.

"Rider 2" was added since our records reflect that not only was the Reg. 1.51 (a) (2) surveillance of trading practices made a subject of the fourth review, but indeed that review indicated that the Exchange had an adequate program which is not reflected in your chart.

Please call the undersigned if you should have any questions on the foregoing.

Very truly yours,

Joseph J. O'Neill
Vice-President and
Secretary

JON/dmg
Enclosures

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NEW YORK COTTON EXCHANGE

RIDER 1

While the chronology is correct with respect to the New York Cotton Exchange's position, we think that the tone and purpose of the Exchange's discussion with the CFTC is missing. For this purpose, we would like to draw from a letter, dated September 11, 1980, from James V. Gargan, House Counsel of the New York Cotton Exchange, to Mr. Daniel Driscoll of the Commission's staff; as well as from the letter of J. William Donaghy, President of the Exchange, to John Manley, dated November 18, 1980.

The point in question is addressed at length in the September 11, 1980 letter:

> Point No. 3 on page 12 of the draft report stands for the proposition that when an Exchange's staff comes across possible violations of any Rule promulgated by the Commission that the Exchange staff should notify the Commission. We have consistently advised the Commission staff that we have difficulty with that proposition, chiefly because the reporting requirements contemplated therein are so open-ended and so broad as to be without limitation. In essence, the Exchange's position is that were the Commission to adopt a Rule which required such notification, we would, of course, comply. Without sponsoring such a proposed Rule, we think that the rule-making process would be such that any Rule adopted would have the sufficient specificity to allow Exchanges and, indeed, the Commission staff to know when, where, and what potential Rule violations would be subject to report.
>
> To demonstrate even more graphically the problem posed by the Division's present position, let us consider that a Compliance Investigator for the Exchange is investigating a case in which it appears to him that a potential riskless transaction was effected in violation of the Exchange's By-Laws. Should he or should he not report this matter to the Commission as a potential wash sale? If so, when should he report it?
>
> Condider further that the cornerstone for suspecting the potential riskless transaction and advising the Commission of a potential wash sale was erroneous advice from the carrying FCM, that Account No. 1 which bought futures contracts and Account No. 2 which sold the same futures contracts in the transaction are owned by the same A. Jones. Thereafter, let us assume that the Compliance Investigator sought written confirmation from the FCM of its earlier oral advice with respect to the common ownership of the account;

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Rider 1.
Page 2.

and that at this juncture, the FCM discovered its error and advised the Investigator that the accounts were not commonly owned. Assume that the correction of that error leaves the Investigator with no reasonable cause to believe that an Exchange Rule violation has taken place, is he now required or expected to advise someone at the Commission of this new information and the fact that the Exchange investigation has appropriately been closed out?

A plain reading of paragraph 3 on page 12 of the draft report demonstrates that it is the position of the Division's staff to require the Exchange to report the above hypothetical case, but that position is based upon Subsection (f) of FINANCIAL AND SEGREGATION NUMBER 4 issued May 17, 1979. Query whether wash sales were a type of potential violation envisioned by such Interpretation dealing as it does with financial and segregation matters?

Such fundamental questions buttress the proposition that if the Commission has a clear, definitive need to receive specific information from self-regulatory Exchanges, it should be done by means of rule-making by the Commission rather than by the staff.

As an example of this former approach, when the Commission determined that it was important for it to know as quickly as possible when an FCM was experiencing a clear and measurable shortfall in its adjusted net capital or when an FCM was subject to a material inadequacy or when its books and records were noncurrent, it met that clear, perceived need by the adoption of Reg. 1.12, which requires FCM's and other registrants to report such events when the registrant knew or should have known of such occurance. Additionally, the Commission, by such Rule making, placed on Exchanges the responsibility of reporting to the Commission instances in which it is learned that FCM members had failed to make such reports.

Other instances in which the Commission has adopted Rules requiring Exchanges to report adverse information to the Commission with respect to members are found in Commission Reg. 9.11 through 9.13. Those regulations provide that the Exchange may only make such reports once Exchange disciplinary action with respect to such members has become final. Additionally, Commission Reg. 9.11 (c) permits the Division to request additional and supplementary information from an Exchange with respect to such adverse actions if it so sees fit. However, and this is an important additional proviso, the same regulation requires the Exchange to advise the member of the Division's request and makes provision to allow the member to get copies of any such additional information provided to the Commission.

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Rider 1.
Page 3.

> Harkening back to the earlier example, if such notice is demanded by the Commission when an Exchange is dealing with a member whom it has found after a hearing to have violated its Rules, what notice does the Commission expect an Exchange to follow in these 'Interpretation 4' cases? Should we indicate to the A. Jones owners of both accounts that not only were they targets in an Exchange investigation but that the Exchange had informed the Commission that it had reason to believe they had violated the Commission's Rules (albeit based on erroneous information from an FCM)? Again, if the Commission determines that it does need information with respect to potential Rule violations before they are subject to Reg. 9.11 notice, we believe the Commission should address it through the necessary discipline of Rule making so that it might issue a Rule which clearly and succinctly defines when, where, and what type of information it is to receive in order to effectively regulate its registrants. Indeed, it has been suggested that minor amendments to Reg. 1.12 dealing solely with the responsibilities of Exchanges might well solve the problems stated herein. We do not know if such would be the case but we certainly think that such a course would recommend itself instead of relying on Interpretation No. 4.

In response to Mr. Manley's letter of September 24, 1980, we acknowledged that Mr. Manley's letter had indicated that the Exchange's audit and financial surveillance program " . . . was, for the most part, satisfactory and that its overall execution had been good."

Mr. Donaghy then dealt with the five points that were raised in the Manley letter of September 24, 1980, including point three therein as follows:

> 3. 'The Program should be amended to require that the Commission be notified of violations of Commission regulations when such violations are discovered by the NYCE during its audit and financial surveillance activities.'

Mr. Donaghy replied:

> The Exchange has consistently informed the Division that it has difficulty with this suggestion. Rather than repeat the discussions we have had on this matter, we are enclosing a copy of our September 11, 1980 letter to Mr. Dan Driscoll which spoke at length on this subject.

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Rider 1.
Page 4.

> Our understanding is that the Commission has been provided with copies of that letter.

Mr. Donaghy's letter ends by saying:

> We are gratified that the Division recognizes that our captioned Program has been satisfactory and its execution has been good, and we appreciate the comments that have been made by the Division Staff in helping us further amend our Program as set forth in the attached revised manual. We certainly want to work with the Division in reaching an amicable understanding with respect to Point 3 herein.
>
> In that connection, we believe it might be useful to meet with you and your Staff at your earliest convenience. We think that this is an area concerning which our comments might be helpful to the Commission and look forward to meeting with you at your earliest convenience.

We think the foregoing adequately demonstrates that the tone and purpose of the Exchange's discussions with the Commission on this matter reflect an attempt to be helpful and constructive. We weren't sure that that was adequately conveyed by the summary set forth in Chapter 6 and appreciate this opportunity to add what we believe are essential elements to the record.

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NEW YORK COTTON EXCHANGE

RIDER 2

We have placed the GAO symbol "O" herein based on the review letter dated February 21, 1980 from John L. Manley, Director of the Division of Trading and Markets to Mr. William Donaghy, President of the New York Cotton Exchange.

That letter says in part " . . . the Exchange had an adequate program to conduct surveillance of trading practices as required by Reg. 1.51 (a) (2)." (emphasis added)

The letter continued "The Division found that the Exchange had corrected deficiencies which were observed during the last rule enforcement review which reviewed the Exchange's operations during 1977."

The letter also stated:

> In addition to remedying deficiencies previously noted, the Division noted other positive aspects to the Exchange's rule enforcement program. The compliance staff has been increased, and individuals on the staff have been assigned specialized functions. The staff displayed a knowledge of commodity trading and understood their work assignments. A manual describing compliance procedures has been developed. Overall, the Exchange had good operating procedures for surveillance of potential trading abuses which were based on reviewing trade registers. As noted above, this surveillance will now be coupled with an improved program for continuous floor surveillance.

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New York Mercantile Exchange

Office of the President

March 25, 1982

Henry Eschwege, Director
Community and Economic Development Division
United States General Accounting Office
Washington, D. C. 20548

Re: New York Mercantile Exchange Comments on Draft Report Concerning Commodity Futures Trading Commission

Attention: Mr. Ralph Lowry

Dear Mr. Eschwege:

The New York Mercantile Exchange appreciates this opportunity to comment upon those portions of your draft report concerning the Commodity Futures Trading Commission which relates to the Exchange. We apologize that our response is not as timely as you may have wished; nonetheless, we are certain that you will give it due consideration.

We agree that the conclusions of the Commission's Division of Trading and Markets and its Division of Enforcement appear to conflict. Nonetheless, there may be several, somewhat obvious, reasons which explain the apparent inconsistencies. In the first place, the Division of Enforcement's inquiry into trading on the Exchange ostensibly covered the period January 1977 through January 1979. The Division of Trading and Markets focused on the state of the Exchange at the time of its audit, or about May 1980. It is wholly plausible, given that almost eighteen-month span, that the conclusions of both Divisions may have been warranted.

Secondly, your draft report appears to assume that the Division of Enforcement was right while Trading and Markets was wrong. That assumption may not be altogether well-founded. Your draft ignores the salient fact that while the Division of Enforcement made many allegations, not one of them was ever tested in any Court. To be sure, the Exchange did agree to settlement with the Commission, but your draft overlooks that the Exchange admitted not one of Enforcement's charges. As stated in the offer of settlement "...the Exchange does not admit or deny the allegations or findings made by the Commission against the Exchange in this proceeding; nor shall anything in this offer be construed to be or offered as an admission..." For the record, we would add that the Exchange believed it had meritorious defenses to raise in any action brought by the Commission.

Your draft report also mentions that, shortly after the settlement, the Commission approved several Exchange contract market designations applications. To our mind, the consensus of which you speak was more posturing to explain the apparent

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inconsistency in Commission actions than any real doubt about the state of the Exchange's rule enforcement program. When those approvals were made, the Commission had no basis upon which to act otherwise. At that time -- and today as well -- the Exchange's rule enforcement program "satisfied all important statutory and CFTC requirements."

In your draft report, you quote an Exchange Vice President. It should be clear that he was expressing his own opinions and was not speaking on behalf of the Exchange. Indeed, the Exchange does not agree with him. In our opinion, a regulatory body can either issue broad interdictions to those it regulates to obtain its regulatory aims, or it can break down the goals of regulation into discreet programs which, if followed, will permit realization of those objectives. Furthermore, it seems reasonable that if the existence of specific programs is mandated and the programs put in place, then more likely than not, the regulated entity will carry out the programs. Accordingly, we see nothing startling in Trading and Markets' concern over our programs. And, it has hardly been our experience that the Division's concern stops at merely checking to see if a program exists. In addition, and as you might imagine, the Exchange totally disagrees with its Vice President's conclusions regarding Trading and Markets' May 1980 report and the quality of the Exchange's compliance program at that time.

The New York Mercantile Exchange thanks you for this opportunity to give its views. Should you require anything further, please do not hesitate to call.

Sincerely,

Richard C. Leone,
President

RCL/pb

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March 12, 1982

Mr. Henry Eschwege
Director
Community and Economic Development
Division
United States General Accounting
Office
441 G Street, N.W.
Washington, D. C. 20548

Dear Mr. Eschwege:

This is in reply to your February 19, 1982 letter which, unfortunately, never was delivered; but we obtained a copy from Ms. Jane Goldman on March 11, 1982. In your letter you request comments with respect to specific pages of your draft report which refer to National Futures Association (NFA). I thank you for this opportunity to respond on behalf of NFA.

In connection with your review of the CFTC's program for market surveillance of trading on the commodity futures exchanges, you discuss alternate methods of making large trader data available both to the exchanges and to the CFTC. Currently the CFTC requires filing with it of reports by large traders. You suggest two alternatives to requiring the exchanges to collect this large trader data: (1) the CFTC would continue to collect the data and routinely supply it to the exchanges for a fee; or (2) NFA would collect it and disseminate it to the CFTC and the respective exchanges. NFA does not and will not have any responsibility or role in surveilling the markets of the respective exchanges. Accordingly, NFA would have no use for the large trader data and would merely be supplying a service for the CFTC and the exchanges. While such a service may be feasible at some point in the future, NFA's resources will be initially applied to fulfilling the responsibilities and functions authorized by its Articles of Incorporation and by the CFTC in approving

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its registration and rules. We note in your report that some exchange and CFTC market surveillance officials have questioned NFA's ability to develop and run a system in its earlier stages of development. We also note that those same officials apparently question whether it would be appropriate to entrust confidential large trader data to NFA when it has no specific function for which it would need that data.

With respect to the CFTC's registration program, you note in your draft report that under the current Commodity Exchange Act only registration of associated persons ("APs") is specifically authorized to be transferred to NFA and that congressional authority is required for NFA to undertake the registration of FCMs, CTAs, CPOs and floor brokers. Legislative recommendations proposed by NFA would specifically authorize the transfer to NFA of the registration of all categories of registrants, except floor brokers, who will not be members of NFA. Thus, we fully concur in the report's recommendations that Congress specifically authorize NFA to undertake the registration of FCMs, CTAs and CPOs. We do not believe NFA should have responsibility for registering floor brokers since they will not be NFA members. However, we will be happy to assist the CFTC with processing such registrations.

In Chapter 6 of your draft report you note that one of the primary functions of NFA will be to audit and conduct financial surveillance of those FCMs that are not members of commodity exchanges. NFA's registration statement also provides that over time the commodity exchanges may wish to delegate to NFA their audit functions, which NFA would assume by delegation.

Finally, you note in Chapter 8 of your report that arbitration provides a far more rapid forum for the resolution of claims and that NFA's arbitration program will provide the opportunity for a nationwide forum which will overcome some of the problems identified with the commodity exchange programs. NFA has recently recommended legislation to the Congress (amending Section 14 of the Commodity Exchange Act) to provide for arbitration under the auspices of national futures associations registered under Section 17 of the Act and whose rules meet various requirements to supersede the CFTC's ineffective reparations program. This legislative

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Mr. Henry Eschwege
March 12, 1982
Page 3

recommendation also would remove the $15,000 limitation that currently applies to arbitration proceedings before a national futures association and to authorize commodity exchanges to delegate to a qualified national futures association the exchanges' responsibility to provide arbitration.

For your convenience I am enclosing a copy of National Futures Association's legislative recommendations and supporting material. I call your attention specifically to pages 1 through 4 of the draft bill.

Sincerely,

Mahlon M. Frankhauser
Counsel for
National Futures Association

Enclosures

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U.S. Department of Justice

Antitrust Division

Office of the Assistant Attorney General
Washington, D.C. 20530

5 MAR 1982

Mr. William J. Anderson
Director
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Re: GAO draft report entitled "Commodity Futures -- Rapid Growth Requires Improved Federal and Industry Roles"

Dear Mr. Anderson:

This will reply to your letter of February 24, 1982, to Attorney General Smith, enclosing a General Accounting Office ("GAO") draft report entitled "Commodity Futures -- Rapid Growth Requires Improved Federal and Industry Roles" ("draft report"). You have invited the Department of Justice to comment on two specific matters: (1) whether there is a right of private action in Federal court under the Commodity Exchange Act and (2) the impact on competition in the marketplace of an expanded role for industry self-regulatory organizations. We believe that we can provide insight on the second question. Since we have little to add to GAO's analysis of the first question we do not address it below.

We agree with what we understand to be GAO's view, that self-regulation is generally desirable both because it tends to be effective and efficient and because it tends to reduce government expenditures. Thus, for example, we are in general accord with GAO's views concerning self-regulation by exchanges (also called "contract markets"). However, we doubt that the National Futures Association ("NFA")--a compulsory membership registered futures association consisting of most segments of the industry including the exchanges--will be effective and efficient. Indeed NFA is unlikely to reduce the the overall cost of regulation of the commodity futures industry. We are further concerned that NFA, in

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part because it is a mandatory membership organization 1/ which is to encompass all industry segments, is likely to result in reduced competition within the commodity futures industry.

The draft report points out in several places that NFA was approved without a clear understanding of what NFA would do. See, e.g., draft report, pp. iv, 59, 66, 81 and 83. For example at p. 68 of the draft report the authors state:

> CFTC has done little since the NFA was incorporated in 1976 to identify and plan for the sharing of registration functions and related activities with NFA; it has done little to define its future oversight role with respect to the NFA; and it has not determined what type of information it will need to carry out this role or how it will receive needed registration information from NFA.

Nonetheless, the draft report reflects general optimism concerning NFA's future operations. For the reasons set forth below, we do not share that optimism about NFA's operational prospects, and we are concerned as well that NFA may impose a high competitive cost for whatever benefits it might convey. Furthermore, there are less anticompetitive alternatives to NFA which are both more efficient and more likely to achieve the legitimate goals of the CFTC.

Background

As a general rule, in the absence of outside restraints, any continuing market develops its own system of self-regulation. An obvious example of this can be seen in the early history of the securities exchanges, but the same development can be found in the history of any market. Organized markets simply cannot function in the absence of rules and regulations governing their participants behavior. Thus, "[a] futures market . . . is innately self-regulatory." 2/

1/ In theory industry participants can join either NFA or a comparable self-regulatory organization. However, no comparable organization exists, or appears to be contemplated, thus membership in NFA would be, as a practical matter, mandatory for all commodity futures industry participants who deal with the public. Furthermore, it is unlikely that the CFTC would encourage another RFA since CFTC has argued that the tasks it plans to allocate to NFA are best handled by a central industry-wide group. See CFTC Annual Report, 1981, pp. 25-27.

2/ Jones and Ferguson, Competition and Efficiency in the Commodity Futures Markets 3 (May, 1978) ("Jones and Ferguson").

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Congress amended the Commodities Exchange Act (the "Act"), 7 U.S.C. § 1 et. seq., to establish CFTC in 1974 as a result of its dissatisfaction with the existing mix of self-regulation and Department of Agriculture regulation. In addition to the undeniably useful role of the exchanges, each of which is a self-regulatory organization ("SRO") organized under the Act, the statutory framework created a place for other self-regulatory organizations, called registered futures associations ("RFA"). CFTC was directed by the statute to approve such RFAs only if they serve the public interest. The Act currently permits CFTC to delegate functions both to the exchanges and to RFAs as long as CFTC retains oversight. The individual exchanges control the heart of the commodity markets because they create futures contracts and control the conditions of their purchase and sale. The inherent self-regulatory structure of the contract markets encompasses the control of all trading on the exchanges. In contrast, there are no specific functions which a RFA must naturally assume, and the intended functions of RFAs were not spelled out in the 1974 amendments.

In 1978, after the Department's successful opposition to the first application of the NFA for approval as a compulsory membership RFA, § 17(m) of the Act, 7 U.S.C. § 17(m), was amended to permit CFTC to require membership in an RFA if the CFTC determined that mandatory membership was "necessary or appropriate" to the purposes and objectives of the Act. This amendment responded to fears that the objectives of the CFTC would be frustrated "if futures industry professionals were free to discontinue their membership in the relevant association . . . when their acts and practices came under scrutiny or investigation . . . ." S. Rep. No. 95-850, 95th Cong., 2d Sess. 31 (1978).

In 1981, the NFA made its second application to be the umbrella RFA covering all participants in the futures markets who deal with the public, including futures commission merchants, commodity pool operators, and commodity trading advisors. Over the objection of the Department of Justice, NFA's 1981 application was approved.

Discussion

The issues of mandatory membership and of self-regulation should be distinguished conceptually, although they are, as a practical matter, interrelated. Self-regulation is intended to save the CFTC time and expense by shifting the tasks of analysis, rule formulation, and rule enforcement to the industry, leaving the CFTC with only an oversight role. Mandatory membership provisions, on the other hand, are intended to solve a perceived "free rider" problem. The free rider problem in this context refers to the situation where RFA members can withdraw from membership to avoid discipline, and non-members can benefit from the activities of the RFA without contributing to its cost and without subjecting

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themselves to the association's requirements. It was this free rider concern that motivated Congress in 1978 to permit mandatory membership in RFAs. 3/

We believe the issue of mandatory membership RFA's encompassing the entire industry should be reevaluated. Any such reevaluation would, we believe, lead to the conclusion that the costs of NFA will far outweigh any benefits it may offer. There are several reasons underlying that conclusion. First, since each exchange has the power to promulgate rules to control its members, the only regulatory function an RFA could perform which the exchanges cannot perform is regulation of "off-exchange" market participants. NFA's function has been analogized to that of the National Association of Securities Dealers ("NASD"). 4/ However, that analogy does not hold. NASD's authority is limited to the over-the-counter "market," that is, trading conducted away from the organized securities exchanges. Over-the-counter trading represents an important separate segment of the securities business. Unlike the securities markets, virtually every commodity futures trade must be conducted on an organized exchange market. Moreover, in contrast to NFA, which grants the contract markets disproportionate voting power on NFA's board of directors, securities exchanges are not members of NASD. Thus, in the commodity futures industry, unlike the securities industry, no material class of transactions falls outside exchange control. That being the case, the exchanges are the natural focus for self-regulation of commodity futures transactions. Since the exchanges must as a practical matter engage in self-regulation of virtually every commodity futures trade, it is clear that much of what NFA could be called upon to do would simply duplicate or supplant exchange self-regulation of its members. Since exchange members are already supervised by at least one self-regulatory organization, as to them there is no significant "free rider" problem for any RFA to address. 5/

Second, as to firms which belong to no contract market, CFTC currently supervises them directly. If they were to join an RFA which supervised them, the CFTC might be relieved of some burden.

3/ Mandatory membership is not an issue for contract market SROs since seats on exchanges are purchased and privileges to trade include requirements that the exchanges' rules be followed.

4/ NASD itself is not a compulsory membership organization although there are substantial incentives for joining it.

5/ We also note that the contract markets have been moving to reduce duplicative burdens on industry participants without NFA. For example, joint auditing plans were approved by CFTC in 1980. CFTC Annual Report, 1980, p. 122.

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However, the free rider problem which has been suggested as a justification for mandatory membership in an RFA does not stand scrutiny. If a firm belonged to an RFA and quit in the face of a disciplinary proceeding against it, CFTC could, in almost every instance, continue that disciplinary proceeding under the Act or CFTC regulations. Thus, resigning from an RFA would not provide an escape from disciplinary proceedings. Second, CFTC has existing authority to impose rules comparable to those of an RFA, and the authority to assess the firms it regulates directly for the cost of CFTC regulation. 7 U.S.C. § 21(d)(e). Given that authority, non-RFA members should not enjoy a "free ride" at the expense of either RFA members or the taxpayers. This is not to say that no situation could exist which would justify a mandatory membership RFA limited to industry participants who are not members of a contract market. Rather, it is to say that the structure of the commodity futures industry does not compel mandatory membership in an industry-wide RFA in order to achieve efficiency and avoid free rider problems.

It is also important to recognize that even if certain regulatory functions are identified which are not ideally suited to regulation by contract market SROs, NFA does not represent the only alternative. Indeed, for regulation of non-exchange member futures market participants, we have identified other less anticompetitive, and at least as cost effective, alternatives to NFA. For example, auditing of non-contract members could readily be contracted to a private firm by the CFTC. 6/ Furthermore, CFTC has proposed amendments to the Act which would enable the CFTC to share information with state and local authorities and give those authorities power to prosecute illegal off-exchange activity under state law. Both measures would reduce the oft-cited problems of non-exchange member abuses which have been raised as a principal justification for NFA.

We now turn to a brief review of the merits and problems inherent in NFA's structure, including both the prospect of NFA relieving CFTC of any substantial burden and NFA's likely effects on competition. The benefits of self-regulation depend on a number of factors. The most important is the degree to which the regulatory function can be shifted at the same or lower cost from the CFTC to the RFA, and not merely duplicated by the RFA. In theory, oversight should be less time consuming for CFTC than primary regulation because standards of review can be established that obviate the need

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6/ See the comments of the Department of Justice filed in the National Futures Association--application to the Commodity Futures Trading Commission for Registration under Section 17 of the Commodity Exchange Act, filed July 2, 1981, ("NFA Comments") for similar examples. A copy of these comments is enclosed.

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for extensive review in the majority of cases. The optimal RFA will have the following characteristics: there will be minimal fundamental conflicts of interest among its members, its rules will be limited and will not provoke multilateral controversies, its governing board will be knowledgeable and familiar with the problems of those it seeks to regulate, and its actions will rarely require extensive review. The exchanges meet these criteria. The NFA as presently structured fails to meet them.

Given the NFA's status as an umbrella organization, there exist apparent and dramatic conflicts of interest among various groups within NFA's scope. Indeed, there is an inherent danger that one or two industry segments will be able to dominate the others unfairly. 7/ For example, since trading advisors and pool operators compete directly with futures commission merchants, control by futures commission merchants through the NFA of the methods by which commodity pool operators and trading advisors are allowed to compete has serious competitive implications. These clear conflicts may result in the promulgation of unfair and anticompetitive NFA rules. Moreover, by bringing together competing groups such as commodity pool operators and futures commissions merchants, it is likely that competition and innovation will be limited. The CFTC will, therefore, be required to review the NFA's rules frequently and in great detail to prevent abuses. Such review precludes any significant savings, and, in fact, unnecessarily burdens the commodity markets by needlessly imposing an extra regulatory layer. Each of the criteria mentioned above can be similarly analyzed. For each, an umbrella organization like the NFA is likely to impose additional regulatory costs instead of savings. Moreover, it appears that all the exchanges will be members of NFA and will control 13 of NFA's 40 directors. Since the exchanges compete with each other in areas such as contract terms, hours, and commodities traded, bringing them together within the NFA creates the prospect that the exchanges themselves will inhibit these competitive forces and have a stifling effect on exchange innovation. 8/ Given the

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7/ The anticompetitive problems presented by the NFA are discussed more fully in the enclosed NFA Comments.

8/ See Silber, W, "Innovation and Competition and New Contract Design in Futures Markets," The Journal of Futures Markets, Vol 1, No: 2 (Summer, 1981); Jones and Ferguson, op cit. especially Chapter VI; see generally the Report of the CFTC Advisory Committee on the Economic role of Contract Markets, July 17, 1976.

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limited number of exchanges and the fact that they operate in a regulated environment, it is particularly important that existing rivalry among the exchanges not be decreased.

The Antitrust Division therefore concludes that § 17 should be modified to preclude an industry-wide, mandatory membership RFA like the National Futures Association. The potential benefits of such an organization are at best limited and are more than outweighed by the additional regulatory burdens and possible anticompetitive effects that such an organization can be expected to impose.

While we believe that precluding industry-wide, mandatory membership RFA's is perferable, we note one more limited option which would reduce the anticompetitive effects likely to follow from NFA. A possibility would be to prohibit a mandatory membership RFA from containing more than one class of members. For example, any organization having futures commission merchants as members should not also have commodity pool operators as members. Further, exchanges should not be RFA members since they are themselves self-regulators. This solution would cure any perceived free rider problem while sharply reducing the potential for anticompetitive action. Since the organizations would be differentiated by function, mandatory membership would not put the smaller industry groups within the power of more dominant groups. Moreover, CFTC review of rules would be facilitated since each RFA rule would be focussed on particular problems of that RFA.

Implications for the Draft Report

At numerous points the draft report takes NFA's industry-wide, manadatory membership features as a given, and points out activities which such an organization could undertake. The draft report also proposes statutory language to expand the authority of RFAs in certain areas. We are troubled by GAO's implicit acceptance of NFA given the fundamental competitive questions raised by the CFTC's approval of NFA. Moreover, we believe that, however careful CFTC's review of NFA's actions may be in the future, it is unlikely that it will be able effectively to detect and prevent anti-competitive problems, and its efforts to do so--which would necessarily be costly and possibly protracted--are likely to remove any cost-savings that self-regulation, properly structured, can have.

For these reasons, we encourage GAO to (1) look again at whether NFA or any similar industry-wide RFA really is a necessary adjunct to commodity futures regulation, (2) consider whether NFA is likely

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to produce the results the draft report suggests are likely and (3) consider whether one or more limited membership RFAs could perform at least as well as NFA, without raising the competitive concerns inherent in NFA.

Sincerely yours,

William F Baxter

William F. Baxter
Assistant Attorney General
Antitrust Division

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